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IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-1305

PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK,

Petitioner,

v.

FEDERAL POWER COMMISSION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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PUBLIC SERVICE COMMISSION OF
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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Petitioner, the Public Service Commission of the State of New York (New York), respectfully prays that a writ of certiorari be issued to review the opinion and judgment of the United States Court of Appeals for the Fifth Circuit entered in this case on October 1, 1975.

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OPINION BELOW

The basic opinion of the Court of Appeals of October 14, 1975, from which review is sought is reported at 520 F.2d 1061. A *per curiam* order on rehearing issued Janaury 14, 1976 is reported at 525 F.2d 1261. These opinions and orders are set forth as Appendix A and B respectively of the separate appendix to Petition for a Writ of Certiorari being filed in this Court under the style of *The California Company, a Division of Chevron Oil Company v. Federal Power Commission.*[1]

JURISDICTION

The opinion and judgment of the Court below was entered on October 14, 1975. On January 5, 1976, Mr. Justice Powell entered an order extending the time within which New York could file a petition for writ of certiorari until March 12, 1976. This Court's jurisdiction is invoked under 28 U.S.C. § 1254 (1) and Section 19 (b) of the Natural Gas Act, 15 U.S.C. § 717r(b).

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[1] For the convenience of the Court the several parties filing petitions from the opinion and orders of the court below agreed that a single appendix incorporating the relevant orders of the Commission and the Circuit Court, and governing provisions of the Natural Gas Act would be filed by the California Company with its petition, but could be referred to as (Pet. App. ____). References to other portions of the record before the Commission printed in the Joint Appendix submitted to the Court below are cited as (J. A. ____).

QUESTION PRESENTED

Whether the Federal Power Commission in a rule-making proceeding limited to fixing a nationwide rate for new gas could properly make this rate automatically applicable to the oldest and lowest cost flowing gas, at a multibillion dollar cost to consumers, whenever the initial sales contract expires and the producer and pipeline enter into a replacement contract, regardless of whether the producer agrees to devote any of the resulting additional revenues to the development of additional gas for the interstate market?

STATUTORY PROVISIONS INVOLVED

The relevant portions of the Natural Gas Act 15 U.S.C. § 717 *et seq.*, are set out as Appendix E to the Appendix to the California Company Petition for Certiorari (See note 1, *supra*).

STATEMENT OF THE CASE

This case arises out of the decisions of the Federal Power Commission in Opinion Nos. 699 and 699-H (Pet. App. C and D) fixing a nationwide rate, at a base price of 50 cents per mcf, for new gas sold by producers in interstate commerce for resale. The instant petition is limited to those portions of the Commission's opinion and orders which made the higher new gas price adopted therein automatically applicable to continued deliveries of flowing gas upon the expiration

of the initial sales contracts therefor and the filing of new contracts covering the same service.

The Public Service Commission of the State of New York is a regulatory body established under the laws of the State of New York having jurisdiction *inter alia* over the operations of distributors of natural gas at retail in the state. Almost all of the gas sold in the state is acquired by those distributors from interstate pipelines subject to the jurisdiction of the Federal Power Commission (Commission), who in turn secure most of their gas directly or indirectly from independent producers pursuant to sales regulated by the Commission. Consequently, New York, in order to protect the interests of gas consumers in its state, has for a number of years found it necessary to participate actively in Commission proceedings involving both the pipelines serving the state and looking towards the fixing of just and reasonable area or national rates for producer sales to the pipelines. In accordance with this established policy, New York participated actively in the Commission proceedings leading towards the opinions in issue here, and brought a review action in the court below challenging the legality of the same facet of the Commission's opinions to which the present petition is directed.

Since we are directing our petition to a single important issue we limit the statement below to those considerations necessary to an understanding of this facet of the Commission's action.

A. The Administrative Background

Since the initiation of group rate making in the *Permian Basin Area Rate Proceeding*, 34 F.P.C. 159 (1965), affirmed *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), the Commission has consistently fixed two sets of just and reasonable rate ceilings, one for flowing gas and another higher level for new gas. The flowing gas rate was and is established essentially to reflect the average historical costs of existing production, but the new gas rates have been fixed on a current cost basis intended to encourage an enhanced gas search effort by the producers. As the Commission found in its *Permian* opinion, 34 F.P.C. at 186, "the two-price system . . . provides a price for the future related to current and future costs and payable only to producers who discover gas-well gas and dedicate their discoveries to the interstate market" while "avoiding windfalls to those producers who acquired and sold gas under lower cost conditions." See also *Permian*, *supra*, 390 U.S. at 798.

The dividing line between new and old gas was normally fixed in the area proceedings at some date around the commencement of the proceeding, and, as a matter of convenience, *Permian* and the subsequent area rate proceedings applied these dates to individual sales on the basis of whether or not the sales contract had been made before or after the date chosen. See 34 F.P.C. at 189. The Commission recognized in its original *Permian* opinion, however, that overly rigid adherence to contract date vintaging could be detrimental to the public interest. Accordingly it instituted therein (34 F.P.C. at 1068-1072) a separate proceeding

leading to Opinion No. 567, *Hugoton-Anadarko Area Rate Proceeding (Committed Acreage)*, 42 F.P.C. 727 (1962) in which it specified that all gas produced from deeper drilling in previously committed acreage would secure the new gas price, regardless of the date of the underlying contracts governing such sales.

This concept was further expanded in 1972 when the Commission in establishing its *Optional Procedure for Certificating New Producer Sales of Natural Gas*, 48 *F.P.C.* 218 (1972), *affirmed* in major part in *Moss v. FPC* 502 F.2d 461 (D.C. Cir., 1974) and as to the remainder by this Court in *FPC v. Moss*, Case No. 74-883, decided March 3, 1976, made its procedure for seeking rates in excess of the established ceilings for new sales of gas applicable to all *wells* drilled after April 6, 1972, regardless of whether the acreage was already dedicated to interstate commerce. In taking this action to "encourage full development of such acreage", the Commission stated its belief that its policy of distinguishing between new and old gas on the basis of contract date "had failed to achieve full development of dedicated acreage" (48 F.P.C. at 227), but it also emphasized that the optional procedure was "directed at supplies of gas not available to the interstate market prior to April 6, 1972. The rulemaking does not authorize rate increases for gas already flowing in interstate commerce through wells drilled prior to April 6, 1972 . . . [thus] consumers will not pay higher rates except for new supplies and then only to the extent that the contracting parties establish on record that the price to be paid is required by the public interest" (48 F.P.C. at 220).

While the Commission continued to maintain the

distinction between old and new gas, it recognized that situations would exist where increases in flowing gas rates could make additional gas available to the interstate market. Procedures for seeking such increases had been written into all of the area rate orders. See *Permian Basin Area Rate Cases, supra*, 390 U.S. at 770,771. And upon proper showings the Commission has in fact granted substantial relief to producers. (See, *e.g. Shell Oil Company*, 49 F.P.C. 108 (1973); *George Mitchell and Associates* 49 F.P.C. 424 (1973). Moreover, on November 8, 1972 the Commission moved to institutionalize this procedure by the issuance in Docket No. R-458 of a proposed policy statement, subsequently finalized on April 23, 1973, to encourage producers to seek rate increases in excess of area flowing gas rates where reduced well pressure, need for reconditioning of wells, deeper drilling or other circumstances made additional production of existing wells uneconomic at existing flowing gas ceilings.[2] In short, as of the time of the initiation of the present proceeding, Commission procedures already existed whereby producers with flowing gas could secure higher rates, before or after the expiration of the initial sales contract, if and to the extent that they could show a need therefor to maintain or increase production. Such procedures were supported by New York and other consumer representatives, as proper exercises of the Commission's authority to "employ price functionally in order to achieve relevant regulatory purposes."

[2] *Policy With Respect to Sales Where Reduced Pressure, Need For Reconditioning, Deeper Drilling or Other Factors Make Further Production Uneconomical at Existing Prices*, 49 F.P.C. 992 (1973), codified as 18 C.F.R. § 2.76.

(*Permian Basin Area Rate Cases, supra,* 390 U.S. at 797.)

On December 12, 1972, however, the Commission suddenly took a different tack. In Opinion 639, the Commission rejected a proposed higher new gas rate for the Appalachian Basin production area (supported by New York) in favor of individual producer utilization of the newly adopted "optional procedure" (See *supra,* p. 6), again stressing that this procedure would permit higher prices for new gas sales where they were instituted without increasing the rates for flowing gas. *Area Rates for the Appalachian and Illinois Basis Areas,* 48 F.P.C. 1299, 1307. However by way of dictum the Commission stated that in view of its objections to "vintaging by contract date" it considered "vintaging to be an anachronism which we should now work to eliminate" (48 F.P.C. at 1309).[3] Accordingly it indicated that it would henceforth adopt a literal interpretation of its various area rate orders under

[3]The Commission attempted to bulwark its statement of policy by suggesting that the Commission had originally contemplated gradual elimination of the two price system, citing for this proposition the Commission's 1960 statement, prior to the initiation of any area rate proceedings, that it expected that the differentials between its "guideline" prices for initial certification of new gas sales and for accepting increased rate filings without suspension would disappear over a period of time. See Statement of General Policy No. 61-1, 24 F.P.C. 818 (1960). In fact, the difference between the initial and increased rate guidelines in most but not all production areas, adopted on an *ex parte* basis by the Commission, were unrelated to the date of original production or contractual commitment to the interstate market, or to the subsequent development of and rationale for the two-price area rate policy.

which sales of flowing gas would be eligible for the higher new gas rates where initial sales contracts had expired and the parties entered into new sales contracts.

The lawfulness *vel non* of this policy was subsequently affirmed in *Shell Oil Company v. F.P.C.* 491 F.2d 82 (5th Cir., 1974), as a permissible exercise of its discretion to interpret its own orders.[4] the Court recognized the potential validity of the claims by New York and others that the gas supply objectives underlying the Commission's policy might be impaired rather than aided and made clear that its action was not to be taken as a blanket approval of all future actions by the Commission to eliminate vintaging: "in each future rate order the Commission must continue to produce substantial evidence to support each essential element of the proposed rate structure" (491 F.2d at 89-90).

B. The Instant Proceeding

The present case was initiated by a notice of proposed rule-making in Docket No. R-389-B issued by the Commission on April 11, 1973 (J.A. I, 1). The proceeding was entitled, "Just and Reasonable National Rates for Future Sales of Natural Gas from Certain

[4]Challenges to specific implementations of this policy statement were recently rejected by a 2-1 vote of the court in *Public Service Commission of the State of New York, et al. v. F.P.C.*, ____ F.2d ____ (Case Nos. 73-1647 *et al.*, D.C. Cir., issued January 27, 1976). It is contemplated that petitions for certiorari from this opinion will be filed.

Wells," and the notice indicated that "the single uniform just and reasonable rate to be determined by final order herein shall apply to all jurisdictional sales of natural gas produced *from wells commenced on or after January 1, 1973*, except sales certificated under Order No. 431 [short-term sales], or Order No. 455 [the optional procedure]" (J.A. I, 1, emphasis added). The Commission made clear in the notice that it intended to institute a separate rulemaking proceeding "for the establishment of a single national just and reasonable rate for gas sold in interstate commerce from wells commenced prior to January 1, 1973" (J.A. I, 6-7). Such a proceeding was, in fact, initiated on May 23, 1973 by Notice of Proposed Rulemaking in Docket No. R-478, *Nationwide Rulemaking to Establish Just and Reasonable Rates for Natural Gas Produced from Wells Commenced Before January 1, 1973*, 38 F. R. 14295.

Comments and reply comments were filed by numerous parties, including New York on May 16, 1973 and June 1, 1973 respectively (See J.A. III, 218, 220, 288, 289). On March 21, 1974, the Commission issued a supplemental notice calling the attention of the parties to a revised staff nationwide new gas cost study and a staff study of certain AGA data. The parties were invited to file new comments on those studies, as well as on five discrete questions propounded by the Commission (J.A. I, 130-132). Again, nothing in the notice suggested the Commission contemplated expanding the proceeding to encompass any flowing gas. New comments in response to the Commission's supplemental notice were then filed by a number of parties. In the supplementary comments filed by a group of the

major producers (J.A. III, p. 310), it was suggested that the Commission, consistent with Opinion 639, should make its nationwide new gas rate applicable to flowing gas sales when the initial sales contract expires and a new one is entered into. This suggestion was opposed by New York in its supplementary reply comments filed on May 29, 1974 (J.A. IV, pp. 644-648).

On June 21, 1971, the Commission issued its Opinion 699 in this proceeding (Pet. App. C). For purposes of this petition it is sufficient to note that Opinion 699 established a nationwide base rate for new gas of 42 cents per mcf, as of January 1, 1973, with one cent escalations annually. This rate was made applicable to interstate sales undertaken:

(1) from wells commenced on or after January 1, 1973;

(2) pursuant to contracts on or after January 1, 1973, for the sale of gas not previously sold in interstate commerce except on a short term basis under certain Commission regulations; and

(3) "pursuant to contracts executed on or after January 1, 1973 where the sales were formerly made pursuant to permanent certificates of unlimited duration under contracts which expire by their own terms on or after January 1, 1973" (Pet. App. C-2 to C-3).

The Commission gave as its reason for changing its proposal to include flowing gas sales that its action was "consistent" with that taken in Opinion 639, would make additional revenues "available" to producers for expanded exploration and development efforts, and would "offset the claimed attrition in rate of return in various discounted cash flow studies presented by

producer respondents" (Pet. App. C-107 to C-108). No mention was made of the pending proceeding in Docket R-478, and nothing was stated in response to New York's contrary arguments. Commissioner Smith dissented from this aspect of the Commission's action, finding it to be unsupported by the likelihood of benefit to gas consumers. (Pet. App. C-230 to C-232).

Numerous petitions for rehearing of Opinion No. 699 were filed. New York's petition (J.A. IV, 729) among others, expressly challenged the Commission's action in making the new rate applicable to flowing gas sales. At the oral argument held on August 22 and 23, 1974, counsel for New York again set forth the reasons why New York believed the new rate should not apply to flowing gas (See J.A. III, p. 55-56), as did counsel for the Associated Gas Distributors (AGD) (See J.A. III, 38-43).

On December 4, 1974, the Commission issued its Opinion No. 699-H (Pet. App. D). In this opinion, the Commission increased the nationwide base rate to 50 cents per mcf. Opinion 699-H totally ignores the arguments made in the petitions for rehearing and on oral argument by New York and other parties opposing the automatic applicability of the new gas rate to flowing gas sold under replacement contracts. It does discuss, however, a number of requests by the *producers* to enlarge the coverage of its order to include even greater amounts of flowing gas within the new gas umbrella (Pet. App. D-43-D-47). While it rejected a request to make the new gas rate available to flowing gas whenever the initial sales contract expires in situations where the producer and pipeline had failed to enter into a new contract (Pet. App. D-45-D-46), it

modified the availability clause to include flowing gas sales where the term of the initial sales contract expired after January 1, 1973, but the replacement contract had been entered into *prior* thereto (Pet. App. D-44).[5]

Commissioner Smith again dissented from the Commission's action making the new gas rate available to flowing gas (Pet. App. D-112 to D-116). He calculated that the cost to consumers could reach as high as $2.6 billion through 1981, without considering any increases in the new gas rate which might stem from the biennial review provided for in Opinion No. 699-H (*id. at* D-114.) He concluded that the Commission's action was inconsistent with its notices in the proceeding, and that even assuming there were a need to provide additional internal financing for producers, making the new rate available to such flowing gas as would become eligible under the Commission's order was a discriminatory and ineffective method of achieving this objective (*ibid*).

On appeal the Court of Appeals for the Fifth Circuit affirmed the Commission in all respects (Pet. App. A). The court agreed that there was much to be said for the arguments of New York, AGD and the American Public Gas Association that automatically giving the new gas rate to flowing gas sold under replacement contracts would inhibit rather than encourage future development. It concluded, however, that the Commission's determination was lawful since it rested on substantial evidence as to the existence of a gas supply

[5] The final form of the provision for making the nationwide new gas rate applicable to flowing gas sales is set out as Section 2.56(a)(3)(iii) of the Commission's Statements of General Policy and Interpretations, 18 C.F.R. 2.56(a)(3)(iii) (Pet. App. D).

deficiency and the need of producers for a "massive infusion of funds" to conduct an optimum gas search effort, and since a review of the efficacy of the particular non-cost bonus adopted by the Commission would be undertaken in the biennial review proceeding the Commission had initiated. (Pet. App. C-112 to C-114).

REASONS FOR GRANTING THE WRIT

The Commission in this case adopted a 50 cent nationwide base rate for new gas, approximately double the previous rate ceilings for such gas. New York does not challenge this determination which we believe was within the Commission's discretion as elucidated by this Court in the *Permian Basin Area Rate Cases*, 390 U.S. 747 (1965) and *Mobil Oil Corporation v. FPC*, 417 U.S. 283 (1974). We do challenge the lawfulness, however, of a multibillion dollar[6] non-cost supplement to this

[6]The exact cost of the allowance depends on several variables not presently known. Commissioner Smith in his dissent estimated the cost through 1981 at 2.6 billion dollars, based upon then current flowing gas rates and assuming no increase in the nationwide new gas rate during this period. If one uses the 24.5 cent flowing gas rate, subsequently fixed in Docket R-478 by the Commission's order of December 31, 1975, (and assumes that the 6 cent increase in this rate as of July 1, 1976 for increased federal income taxes will also be applied to the new gas rates), the cost through 1981 would be in excess of 1.8 billion dollars. And if the replacement contracts continue to secure the new gas rate as it is increased in the biennial review proceedings contemplated by the Commission the cost will be greatly in excess of this figure; thus in the first of these proceedings in

(continued)

rate which resulted from the Commission's decision to classify as "new gas" the oldest and least costly flowing gas whenever the initial sales contract expires and a new "replacement contract" is entered into. Not only was there no record before the Commission which could support the inclusion of this huge non-cost bonus, which differs in both amount and kind from the allowance previously found to be justified by this Court, but the Commission ignored the data in its files indicating that its action would be counterproductive and inhibit rather than encourage additional production efforts for the interstate market.

1. This Court in *Mobil, supra*, has made clear that the Commission is not limited to cost based rates, and, as a matter of rate design, can place some of the burden of the costs for expanding future production upon flowing gas rates and current users thereof rather than imposing the entire burden on the future consumers of newly developed gas. See 417 U.S. at 320. But the Court's approval of contingent escalations of flowing gas rates and refund work-off provisions in the Commission orders in *Mobil* was in context of a Commission decision which (1) had before it for consideration both the old and new gas rates being established for the area involved, (2) involved non-cost supplements which were constructed to "provide opportunity for increased prices that would help in generating capital funds and in meeting rising costs, while assuring that such increases would not be levied upon consumers unless accompanied by increased

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Docket No. RM75-14, the Commission's Bureau of Natural Gas has recommended new gas rates for the 1975-1976 biennial ranging between 85.32 and 169.99 cents per mcf.

supplies of gas" (*id.* at 318), and (3) resulted from the Commission's evaluation of "massive evidence" as to the probable effect of the two proposals and a genuine effort to "seek answers" to the questions posed by the parties questioning the utility of the specific non-cost allowances (*ibid*). None of these factors are present here.

There was no Commission effort in this case to determine the effect of classifying flowing gas sold under "replacement contracts" as new gas. The Commission's several notices in the present rule-making proceeding were expressly limited to the establishment of costs for new gas from "wells commenced after January 1, 1973" (J.A. I, p. 1) with consideration of the appropriate rates for flowing gas from wells commenced *prior* to January 1, 1973 set aside for consideration in a separate rule making proceeding in Docket R-478 initialed on May 23, 1973, shortly after the start of the instant proceeding. And while the Commission directed a number of specific inquiries to the parties (J.A. I, pp. 130-132), none of them related to "replacement" contracts or in any way suggested that the new gas proceeding would be expanded to cover such flowing gas sales. The result is that while some of the producer comments suggested in general terms that old gas sold under "replacement contract" should be afforded the new gas rate, and New York filed brief comments in response (J.A. I, pp. 644-645), there was no record upon which the Commission could determine whether the total revenues available to the producers were inadequate to fund an optimum gas search effort, or the relative percentage of total revenues which should be borne by the rates fixed for flowing gas sales.

Moreover, the Commission refused to evaluate available data useful in determining the efficiency of automatically authorizing flowing gas sold under replacement contracts to secure the much higher new gas rate. New York, among others, had asserted in its comments and petition for rehearing (J.A. IV, p. 729) that permitting producers to secure new gas rates for their flowing gas without any requirement that they devote at least a substantial portion of the increased revenues towards additional production efforts for the interstate market would inhibit actions which the producers might otherwise be induced to take in response to a higher rate for their flowing gas. Under existing gas supply exigencies, we contended, the pipelines would not be in a position to require the producer to agree to expend substantial additional sums for further developmental work for the benefit of the pipeline as a condition for entering into a new contract.[7] And if the producers were entitled to secure the higher new gas rate whenever a replacement contract is entered into, regardless of its terms, the efficiency of existing Commission policies and rules offering producers the prospect of higher rates where they were prepared to make additional expenditures to

[7] In the absence of a new contract the producer is required to continue service unless and until abandonment is authorized by the Commission. *Sun Oil Company v. FPC*, 364 U.S. 170. And while the producer at the end of the contract period is free of contractual limitations on filing for increased rates (*United Gas Pipeline Co. v. Mobile Gas Service Corp.*, 350 U.S. 332), such filings are subject to Commission moritoria and to the procedures of Sections 4 and 5 of the Natural Gas Act which lead to their denial where the increase has not been shown to be justified.

increase the available gas supply,[8] would be seriously impaired.

We did not ask the Commission to accept our argument solely on the basis of its logic. Instead, we pointed out that the Commission had had experience with a similar if more limited experiment pursuant to its 1972 Opinion No. 639[9] and asserted that an examination of the contracts filed in connection with that

[8]New York pointed out that the Commission had established the procedures referred to in the statement *supra* at p. 7 to encourage producers to seek rates in excess of the established flowing gas ceilings when they could show that continued or increased production was uneconomic at these norms.

[9]In its brief below the Commission asserted that it was not able to evaluate the effect of the Opinion No. 639 program since that action had not been finally approved by the Court of Appeals until April 15, 1974, when it denied petitions for rehearing of its decision in *Shell Oil Co. v. FPC*, 491 F.2d 82 (5th Cir., 1974). However, as of that date Opinion No. 639 had been in effect for over two years, and as of March, 1974, eight months *before* the Commission issued Opinion No. 699-H, there had been over 210 filings of "replacement contracts" by producers seeking to take advantage of the Commission's interpretation of its rate orders in Opinion No. 639.

It should further be noted that the Circuit Court, in affirming the Commission's experimental program involved the *Shell* case, as a permissible interpretation of previous orders, recognized that New York's "pessimistic prediction of producer behaviour" may "in time prove justified." (491 F.2d at 89), and specifically warned that it would expect similar Commission actions in future rate orders to "be supported by substantial evidence" (*id* at 89-90). See also *Public Service Commission of the State of New York v. FPC*, 467 F.2d 361, 371 (D.C. Cir., 1972) where the court in approving another experimental non-cost increase in producer revenues, since abandoned by the Commission as

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program would demonstrate that of cases no significant new producer efforts were promised in return for the contract permitting them to increase their rates. (J.A. IV, pp. 735-736). The Commission not only made no such inquiry, but totally ignored New York's contentions in Opinion Nos. 699 and 699-H. Nor did it make any effort to consider other means of providing any additional revenues to the producers which would not have the defects of its "replacement contract" plan.[10]

2. The court below recognized that under the standards laid down in *Permian* and *Mobil, supra* it has the "responsibility . . . to make sure that the Commission has exercised its discretion after considering all pertinent options" (Pet. App. A-29). However, it did not, and could not find that the Commission had considered the consumer arguments as to the disutility

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non-productive, stated:

> "Fundamental to the concept of any experiment is the assumption that the data developed from the experience thereunder will be subjected to meaningful review, analysis and evaluation before the experimental practice is allowed to continue or to become institutionalized as a more permanent procedure."

[10]If any non-cost allowance not tied to actual expenditures could be justified, it could be accomplished with greater equity among producers and without depriving producers of an incentive to engage in additional production to secure higher rates for their flowing gas, by an across-the-board allowance of several cents per mcf in flowing gas rates such as the Commission had previously authorized in its second *Permian Basin Area Rate Proceeding*, 50 F.P.C. 933 (1973). Such a proposal also would have had the advantage of making the additional revenues available at once rather than building up over a period of time as old sales contracts expire.

of affording the much higher new gas rate to replacement contracts without any requirement for a production *quid pro quo* either in the light of its experience with its earlier experiment or in context of the relative bargaining power of the producers and pipelines. All it can point to is the Commission's unsupported hope that the pipelines "might be able" to negotiate for additional efforts on the part of the producers (Pet. App. A-29).

Similarily, while the court found that the multibillion non-cost bonus was "supported", though not "compelled", by the "evidence of a [gas] shortage and the need for a massive infusion of funds" (Pet. App. A-30), it perforce did not suggest there was any record basis for concluding that the industry revenues which would be derived at the much higher new gas rate being adopted and from the nationwide flowing rate still to be fixed in Docket R-478, would be inadequate for this task. Nor could it find that there was any record basis for the Commission's suggestion that a large share of the revenues for producer reinvestment had to be internally generated.[11]

[11]There is no record basis for the Commission's assumption that, because a major share of producer investment funds for gas exploration had traditionally come from internally generated revenues, new funds for an increased gas supply effort could only come from this source, regardless of the price it set for new gas. As the Court of Appeals for the District of Columbia Circuit stated in *Public Service Commission of the State of New York v. FPC*, 487 F.2d 1043, 1073 (1973), remanded *sub nom.* 417 U.S. 964 (1974):

"It is elementary in the petroleum industry that capital is provided for exploration in an area long before there are

(continued)

The Circuit Court apparently felt that the deficiencies in the Commission's findings in justification of its replacement contract caper and in the record support therefore, could be excused because the "experimental" nature of national rate making permitted a "standard of review requiring heightened deference to the Commission's expertise" (Pet. App. A-17), and because it believed the Commission had indicated it would review the program in the biennial review proceeding in Docket No. RM75-14 it had initiated. But there can be no justification for holding the Commission to a lesser standard in its approval of a multibillion dollar bonus to which no obligation for new gas production or even additional production efforts is attached, than was applied by this Court in its evaluation of the contingent escalations of flowing gas rates and the refund work off provisions of the order approved in *Mobil*, where the additional payments were tied to additional gas sales (See 417 U.S. at 318). This is particularly true where, as here, the Commission refused to consider available data with respect to a similar "experimental" program it had initiated almost three years earlier.

Nor can any analysis of whether the Commission's

(footnote continued from preceding page)

any funds flowing from that area – demonstrated, e.g. by the funds invested in Alaska, and in purchase of Gulf Coast off-shore leases offered by the Interior Department. It is obvious that future expenditures in any particular producer area depend on evaluations of future profits, not past or recent receipts from activities begun in the past, at least where, as here, the future operations will be governed by price conditions far more liberal than prevailed at the time current operations were planned and developed."

program is likely to be worth its great cost be put over to subsequent biennial review proceedings. The portion of the Commission's Opinion No. 699-H cited by the Court (Pet. App. A-30) does not relate to the issue of whether replacement contracts should secure the new gas rate, but rather to its determination to permit the new gas rates to escalate as it fixes ever higher rates in its biennial proceedings (Pet. App. D-52-D-56). Even in this context there is no suggestion that any price roll back would be ordered but only that some additional escalations of the rates for new gas might be deferred if at some unspecified future date the program proves to be unsuccessful in inducing new development. We would certainly hope and expect that the Commission will not permit the rates for old flowing gas sold under replacement contracts to increase should the Commission adopt new gas rates in the on-going biennial proceeding at the levels recommended by its staff (See n. 6, *supra*). But surely a multibillion dollar non-cost bonus of the type involved here cannot be justified because the Commission might reject substantial increases therein when it finally agrees it has proven to be ineffective.

This Court made clear in *Mobil*, *supra* that it is the circuit courts which have the primary responsibility for determining whether each major facet of the Commission's decision in an area or nationwide rate case rests on a reasoned analysis of the issues based upon substantial record evidence. The court below, however, was only able to find that there was substantial evidence of the existence of a problem and did not and could not have concluded that the Commission's response thereto of granting new gas rates to the oldest

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portions of the flowing gas supply rested on any factual predicate indicating that any additional gas production which might result therefrom would justify the huge additional cost burden imposed on gas consumers. This failure was, in turn, in large part attributable to the Commission's failure to solicit information as to the utility of the allowance or to avail itself of the data in its files which would have permitted a more meaningful analysis. Under these circumstances, we submit, plenary review by this Court is both appropriate and required to prevent a massive diversion of funds for which little or no public benefit has been shown to be forthcoming.

CONCLUSION

For the reasons set forth above the Court should grant the petition for a writ of certiorari to review that portion of the decision below which upheld the Commission's action in authorizing flowing gas sold under replacement contracts to secure the higher new gas rates.

Respectfully submitted,

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Nos. 75-1289, 75-1299, 75-1304, 75-1305, 75-1306

IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

THE CALIFORNIA COMPANY, A DIVISION OF CHEVRON OIL COMPANY, *et al.*,
Petitioners,

v.

FEDERAL POWER COMMISSION, *et al.*,
Respondents.

On Petitions for Writs of Certiorari to the United States Court of Appeals for the Fifth Circuit

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BRIEF OF RESPONDENT MOBIL OIL CORPORATION IN OPPOSITION TO PETITIONS

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OCTOBER TERM, 1975

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75-1305, and 75-1308

THE CALIFORNIA COMPANY, A DIVISION
OF CHEVRON OIL COMPANY, *et al.*,
Petitioners,

v.

FEDERAL POWER COMMISSION, *et al.*,
Respondents.

On Petitions for Writs of Certiorari to the United States Court of Appeals for the Fifth Circuit

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BRIEF OF RESPONDENT MOBIL OIL CORPORATION IN OPPOSITION TO PETITIONS

Mobil Oil Corporation, an intervenor in support of the respondent Federal Power Commission below and a respondent here, submits this brief in opposition to petitions for writs of certiorari to review the judgment entered in this case on October 14, 1975 by the United States Court of Appeals for the Fifth Circuit.

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OPINIONS BELOW

The opinion of the Court of Appeals is reported at 520 F.2d 1061 (Calco App. A),[1] and the Court of Appeals opinion denying rehearing is reported at 525 F.2d 1261 (Calco App. B). Federal Power Commission Opinion No. 699 is reported at 51 F.P.C. 2212 (Calco App. C); Federal Power Commission Opinion No. 699-H is not yet reported (Calco App. D).

JURISDICTION

Petitioners properly invoke the jurisdiction of this Court under 28 U.S.C. § 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. § 717r(b).

QUESTIONS PRESENTED

Mobil opposes all petitions seeking review of the judgment of the Court of Appeals, supports the position of the respondent Federal Power Commission, and limits this brief to the following questions:[2]

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[1] References are to the separate Appendix to the Petition of The California Company (Calco) filed in No. 75-1289.

[2] In No. 75-1299, Shell Oil Company, *et al.*, seek review of other questions concerning Commission choices of methodology and findings as to costs which the Court of Appeals held to be within the Commission's authority and discretion and supported by substantial evidence (Shell Pet., pp. 3-4, questions 1 and 3).

In No. 75-1304, American Public Gas Association similarly seeks review of Commission choices of methodology, use of data, and decisions as to costs, which were upheld below on similar grounds (APGA Pet., pp. 2-3, question 2).

In No. 75-1304, American Public Gas Association also seeks review of questions of procedure not actually presented in this case (APGA Pet., p. 2, question 1). In this instance, the Commission proceeded on the basis of successive public notices, sworn comments, data and pleadings, reply comments and pleadings, a public conference on specific issues, applications for rehearing, and oral argument (see Calco App. C-3 - C-18, App. D-4 - D-14). These procedures

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1. Whether the Federal Power Commission properly determined that rates prescribed as "just and reasonable" under Sections 4 and 5 of the Natural Gas Act for "new gas," as defined by the Commission, should be applied to natural gas sold by a producer under a new gas sales contract negotiated by the producer and a pipeline purchaser to replace an earlier long-term contract which has expired by its own terms.

2. Whether the Federal Power Commission reasonably found and concluded that (1) natural gas sold at rates established for "new gas" could not be applied to reduce individual producers' refund liabilities and to earn contingent rate escalations as prescribed and permitted by the Commission's earlier area rate decisions; and (b) individual producers should be afforded the option of selling at the new rates or of continuing to sell at area rates and to earn refund credits and rate escalations permitted by the area rate decisions.

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more than met the "minimal requirements" for "rulemaking" to prescribe rates under the Administrative Procedure Act, 5 U.S.C. § 553 and § 556(d), and the "hearing" requirements of Sections 4 and 5 of the Natural Gas Act where there is no genuine issue of disputed material facts (see Calco App. A-23 - A-22). The decision below thus presents no conflict with constructions of the APA and the Natural Gas Act by the Court of Appeals for the District of Columbia Circuit in *Mobil Oil Corporation* v. *FPC*, 483 F.2d 1238 (1973), and is consistent with other decisions of that court holding that where there is no such genuine issue of material fact, neither the APA nor the Natural Gas Act requires formal "adjudicatory" hearings. See *Pennsylvania Gas and Water Co.* v. *FPC*, 463 F.2d 1242, 1245 (D.C. Cir. 1972); *City of Chicago* v. *FPC*, 458 F.2d 731 (D.C. Cir. 1971), *cert. den.*, 405 U.S. 1074 (1972); *Municipal Light Boards of Reading and Wakefield, Mass.* v. *FPC*, 450 F.2d 1341, 1345 (D.C. Cir. 1971); *American Public Gas Association* v. *FPC*, 498 F.2d 718 (D.C. Cir. 1974). Procedures used by the Commission thus represent a permissible middle-ground between "minimal requirements" for "informal rulemaking" under the APA and adjudicatory-type hearings.

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STATUTES INVOLVED

Sections 4, 5, and 7 of the Natural Gas Act, 15 U.S.C. §§ 717c, d, and f, are involved and are set forth in Appendix E to the Petition in No. 75-1289.

STATEMENT

Mobil is an independent producer of natural gas and makes substantial sales in most of the production areas of the United States subject to Commission jurisdiction under the Natural Gas Act. Mobil participated in all proceedings before the Commission in this case and supported the Commission below in seeking affirmance of Commission Opinion Nos. 699 and 699-H. Procedural history pertinent to questions presented is:

1. On December 12, 1972, in its Opinion No. 639, the Commission announced its intention to phase out the so-called "two-tier" pricing or "vintaging" system initiated on an experimental basis in 1960, and to allow natural gas producers to receive the higher "new gas" rate where (1) a gas sales contract expires by its own terms, (2) the producer and the pipeline purchaser negotiate a new long-term contract permitting the higher rate, and (3) the new contract is filed with the Commission as part of an effective rate schedule under Section 4 of the Act. *Area Rates for Appalachian and Illinois Basin Areas*, 48 F.P.C. 1299, reh. denied, 49 FPC 361 (1973).[3]

By notice issued on April 11, 1973 in Docket No. R-389-B, the Commission initiated this case to determine a new uniform national rate for sales of natural gas produced from wells commenced on or after January

[3] This decision was affirmed in *Shell Oil Company* v. *FPC*, 491 F.2d 82 (5th Cir. 1974). Application of the decision to specific contracts and producer rate filings was affirmed in *Public Service Commission for the State of New York* v. *FPC*, —— F.2d —— (D.C. Cir. Nos. 73-1647, *et al.*, decided January 27, 1976).

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1, 1973 (R. 79, 80). In comments filed on May 16, 1973 and during 1974, respondents urged the Commission to apply the policy announced in Opinion No. 639 and permit application of the new rate to new contracts executed on or after January 1, 1973 to replace expired and expiring contracts. Reasons advanced were that such action would be consistent with Commission intent expressed in Opinion No. 639; the new price would encourage recompletions, reworking operations, and installation and maintenance of compression facilities; and the new price would prevent premature abandonment of existing reservoirs (R. 893).

In Opinion No. 699, issued June 21, 1974, the Commission considered the question and concluded that the new rate should apply to ". . . sales made pursuant to contracts executed on or after January 1, 1973, where the sales were formerly made pursuant to permanent certificates of unlimited duration under contracts which expired by their own terms on and after January 1, 1973, in accordance with Opinion No. 639 . . . ." (Calco App. C-2, C-107). The Commission supported this conclusion by reference to the need for additional revenues for expanded exploration and development programs, to offset of claimed attrition in the rate of return reflected in discounted cash flow studies, and to its purposes of encouraging new dedications to the interstate market "whether such new supplies come from new acreage dedications, or from newly drilled wells, or by diversion from other uses" (Calco App. C-108).

Various parties sought rehearing; oral argument followed; and on December 4, 1974, the Commission issued its Opinion No. 699-H, adhering to its decision on this question (Calco App. D-1, D-43 - D-47). In that opinion, the Commission found that claims for a higher rate of return were offset, in part, by the additional revenues to be available under renewal contracts qualifying for the

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national rate (Calco App. D-34); adhered to its views that eligibility was limited to contracts replacing a contract expiring by its own terms and to situations in which the producer and pipeline purchaser executed a new contract; and stated:

> "In many cases, the purchasing pipeline may desire a *quid pro quo* from the selling producer in the form of additional acreage dedication, exploration and development activity on the previously dedicated acreage, or other similar activities that could result in the dedication of additional new gas supplies to the interstate market. Such concessions by the seller certainly will not be made if the price is allowed to increase to the national rate automatically without the requirement of a renewal contract." (Calco App. D-45 - D-46)

In addition, the Commission found that much of the capital required for exploration, development, and production must come from "gas production revenues" (Calco App. D-55), and that the principles adopted would provide additional revenues, as contracts were renewed, and additional capital for exploration and development of "new natural gas supplies for the interstate market" (Calco App. D-55). The Commission also included estimates of such additional revenues in its assessment of impact of its decision upon the industry and consumers (Calco App. D-57).

Commission Opinion No. 699-H thus provides that the new rate applies to sales under new contracts executed on or after January 1, 1973 replacing contracts covering sales made under permanent certificates of unlimited duration which expired by their own terms either prior to or after January 1, 1973 (Calco App. D-78).

On review, the Commission's findings and conclusions were challenged, but the Court of Appeals affirmed (Calco App. A-1, A-27). First, the court found that

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there was adequate notice and a fair opportunity to be heard on the "renewal contract issue" before the Commission (Calco App. A-27). Second, the court found that the Commission had applied the new rate "functionally" with the objective of helping to "alleviate the current severe shortage"; that by requiring the prerequisite of a new contract, the Commission believed the purchaser "might be able to negotiate for additional acreage dedication to interstate commerce, or exploration and development activity on previously dedicated acreage or other concessions for the price increase"; and that the conflicting challenges buttressed the court's "deferral to the reasoned expertise of the Commission" (Calco App. A-29). The court held:

> "The FPC has reached a well-considered, expert decision on this issue. The Commission found from evidence in the record that a massive commitment of new funds is necessary to alleviate the natural gas shortage and that internally generated sums are a necessary source of such funds. Additionally, it noted that by phasing out the vintaging practice and attending price variations, all consumers would more equitably bear the burden of financing added exploration." (Calco App. A-30)

The court further noted that the question would be examined in biennial review of the new national rates, and the Commission had struck "a tentative balance between the consumer and investor interests," which it was prepared to reevaluate, and concluded:

> "Under such a circumstance, no party has carried the heavy burden of showing that the Commission's balance is tilted so far in either direction as to be unjust and unreasonable in its consequence. We also consider the decision, although not compelled by the evidence, to be supported by the substantial evidence of a shortage and the need for a massive infusion of funds." (Calco App. A-30)

* * * *

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"The Commission is not bound by its previous policies. As this Court and the Supreme Court have noted on various occasions, the rate structures which introduced or adjusted vintaging were experimental. It is necessary without a doubt that agencies be permitted latitude to evaluate old experiments and modify or abandon them when their best judgment requires such a course of action." (Calco App. A-31)

2. The Commission provided that the new national rate could not apply to sales of natural gas used to earn credits against individual producers' refund liabilities and escalations of rates permitted by its earlier area rate decisions.

In four area rate decisions, the Commission adopted a "package" rate structure, combining two tiers of rate levels, formulae for discharge of individual producer refund liabilities by dedication of new reserves to interstate purchasers, escalation of rates also tied to levels of new dedications, and moratoria on other rate increases for prescribed future years.[4]

In Opinion No. 699, the Commission determined that producers who elect to discharge their refund obligations by dedicating new supplies under these formulae, or to seek the contingent escalations by such dedications, must continue to price such natural gas at the area rates (Calco App. C-1, C-109 - C-110). The Commission concluded that such treatment was "equitable" and that:

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[4] See *Placid Oil Company* v. *FPC*, 483 F.2d 880 (5th Cir. 1973), aff'd, *Mobil Oil Corporation* v. *FPC*, 417 U.S. 283 (1974); *Texas Gulf Coast Area Rate Case*, 45 FPC 674, ultimately aff'd on remand, *Public Service Commission for the State of New York* v. *FPC*, 516 F.2d 746 (D.C. Cir. 1975); *Other Southwest Area Rate Case*, 47 FPC 99, *aff'd*, *Shell Oil Company* v. *FPC*, 484 F.2d 469 (5th Cir. 1973), *cert. den.*, *Mobil Oil Corp.* v. *FPC*, 417 U.S. 973 (1974); *Permian Basin Area Rate Case II*, 50 FPC 390 (appeal withdrawn).

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> "To allow producers to collect the rate provided by this decision and to discharge their existing obligations and receive the benefits provided under the applicable area rate opinions with the same supplies of natural gas would be contrary to the spirit of the applicable area rate opinions. In essence, we seek to insure that a producer will not receive a double benefit from the rate structure which we establish in this decision." (Calco App. C-110, footnote omitted)

The Commission provided that individual producers must decide whether it is more beneficial to continue under the area rate formulae as to new sales or to obtain the national rate for such sales, and must file waivers as to the escalations and refund credits for sales the producer places under the national rate (Calco App. C-111).[5]

Producers who were beneficiaries of the refund-forgiveness formulae sought rehearing, but the Commission adhered to its conclusions in Opinion No. 699-H (Calco App. D-1, D-63). The Commission pointed out that the refund-forgiveness formulae were components of a total rate design in the area rate decisions, and that it was not reasonable to allow both those benefits and the new national rate for new sales (Calco App. D-64, D-65). In the Commission's view, allowance of both the new rate and the refund credits and contingent escalations allowed by the area rate decisions "would constitute an apostasy" of those opinions (Calco App. D-65).

The Court of Appeals affirmed the Commission, holding:

> "The new national rate is the product of an independent determination of incentives, and, as it is in

[5] For sales placed under the national rate under such an election, the Commission provided for lifting of moratoria on rate increases imposed by the earlier area rate decisions (Calco App. C-115).

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so many other regards, the new rate is not tied to previous determinations. Replacing one incentive structure with another or, viewed in another light, providing a new alternative rate system, is an exercise of Commission discretion which does not amount to retroactive rate regulation. See *Moss* v. *FPC*, 164 U.S. App. D.C. 1, 502 F.2d 461 (1974)." (Calco App. A-42)

ARGUMENT

None of the petitions presents questions requiring or warranting review by this Court:

I. The Court of Appeals Correctly Applied Standards And Principles of Review Required by the Natural Gas Act and Decisions of This Court

Petitioners assert that the judgment below is the result of erroneous application of standards of review under Section 19(b) of the Natural Gas Act and principles expressed by this Court. The assertions are incorrect.

In *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), this Court held that a "presumption of validity" attaches to exercise of the Commission's expertise, and that the functions of the Courts of Appeals under Section 19(b) were determinations of whether (1) the Commission had abused or exceeded its authority; (2) each of the essential elements of the Commission's rate order is supported by substantial evidence; and (3) the order may be expected "to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable" (390 U.S. at 791-792). The court's responsibility is not to "supplant" the Commission's balance of interests, but "to assure itself that the Commission has given reasoned consideration to each of the pertinent factors" (*Ibid*).

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Thereafter, in *Mobil Oil Corporation* v. *FPC*, 417 U.S. 283 (1974), this Court held that application of these criteria is "primarily the task of the court of appeals"; responsibility "to assess the record to determine whether agency findings are supported by substantial evidence" is vested in the Court of Appeals by Section 19(b); and this Court will intervene "only in what ought to be the rare instance when the standard appears to have been grossly misapprehended or grossly misapplied" (417 U.S. at 309-310).

No such "rare instance" is presented. Controlling standards have been correctly apprehended and properly applied by the Court of Appeals. At the outset, the court noted, in express detail, "the *Permian* prescription" (Calco App. A-14 - A-19). The court then applied the criteria to each of the particulars of the Commission's order challenged below. Use of the "national rate" method was found within Commission authority (Calco App. A-20 - A-23); no error was found as to Commission procedures (Calco App. A-23 - A-27); specific cost findings, details of the rate structure, and Commission methods were found to be reasonable and supported by the record and substantial evidence (Calco App. A-27 - A-44); and the "end result" was sustained (Calco App. A-45).

It is correct that the Court of Appeals applied what was termed "kid-glove" treatment on some issues (Calco App. A-19). However, such deference was suggested in *Permian* (390 U.S. at 767, 791-792, 815); and in *Mobil*, this Court quoted with approval the earlier expression by the Fifth Circuit:

> " 'No one can honestly say that judges have been any more sure than commissioners, as all struggle with a problem that grows out of the peculiar mixture of a simultaneous service and exhaustion of a depletable asset. All have been groping. The day for groping is not yet over. And it does not denigrate what FPC

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> has done to say that much may yet be imperfect and much remains to be done or redone. So we can find that FPC has conscientiously attempted to establish 'just and reasonable' rates within the framework allowed by judicial precedent, yet, it is still experimenting' " (*Mobil, supra*, 417 U.S. at 331).

No party, including Mobil, could assert that perfection, however perceived, has been reached in this case. The Commission frankly states that elements of a national rate structure will be reexamined in its biennial review of such rates (Calco App. C-112 - C-114; D-52 - D-56, D-63). The Court of Appeals similarly recognized that its review ". . . must be tailored to the practical requirements of the circumstances," and the burdens of procedural and evidentiary requirements must not be such that they ". . . would either prolong or complicate the task of the Commission to the point of impossibility." (Calco App. A-23).

Principles stated in *Permian* and *Mobil* thus were apprehended properly; standards of Section 19(b) of the Act were applied properly; and the decision of the Court of Appeals raises no questions requiring intervention of this Court.

II. The Court of Appeals Committed No Error In Affirming The Commission Decision To Allow The New National Rate For Sales Under New Contracts Replacing Expired Contracts

Petitioners in Nos. 75-1304, 75-1305, and 75-1308 seek review of the affirmance of the Commission's decision to allow the new national rate for sales under new contracts filed to replace long-term contracts which have expired or expire by their own terms (APGA Pet., p. 3; NYPSC Pet., p. 3; AGD Pet., p. 2). None of the petitions reflects reasons for review by this Court:

1. Petitioners' criticisms are (1) disagreement with the Court of Appeals' holding that the Commission's

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decision is supported by the record and substantial evidence (APGA Pet., pp. 11, 15-16; NYPSC Pet., pp. 15-22; AGD Pet., pp. 8, 10-11); (2) assertions that the Commission decision is lacking in rational consideration (APGA Pet., pp. 14, 16); NYPSC Pet., pp. 18-19; AGD Pet., pp. 6, 8, 11, 13); or (3) arguments that the Commission should have solved the problem addressed with alternatives more acceptable to these particular petitioners (APGA Pet., pp. 15-16; NYPSC Pet., pp. 22-23; AGD Pet., pp. 9-11).

However, each of these arguments was considered fully by the court below; criteria stated in *Permian* and *Mobil* were applied; and the Court of Appeals correctly concluded:

> "The FPC has reached a well-considered, expert decision on this issue. The Commission found from evidence in the record that a massive commitment of new funds is necessary to alleviate the natural gas shortage and that internally generated sums are a necessary source of such funds." (Calco App. A-29).
>
> * * * *
>
> "Under such a circumstance, no party has carried the heavy burden of showing that the Commission's balance is tilted so far in either direction as to be unjust and unreasonable in its consequence." (Calco App. A-30).

2. The Commission decision corrected an anomalous situation existent under the two-tier pricing system initiated in 1960 and is rationally supported.

Under the area-rate system, two separate ceiling rates were prescribed for "flowing" gas and "new" gas, depending upon date of contract. When a long-term contract covering "flowing" gas expired, the producer had the options of (1) seeking "abandonment" of the sale under Section 7(b) of the Act and a new contract with an interstate or intrastate buyer; or (2) continuing the sale,

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filing a unilateral rate increase to the level selected by the producer, and collecting such increased rate subject to refund pending hearings and decisions on reasonableness. See *United Gas Pipe Line Co.* v. *FPC*, 385 U.S. 83 (1966); *Sunray Mid-Continent Oil Co.* v. *FPC*, 364 U.S. 137 (1960).

In 1972, the Commission reviewed this situation, the original Commission intent to phase out the "two-price" "vintaging" system, and the need to encourage prompt negotiation of replacement contracts. In its Opinion No. 639, the Commission thus concluded that when the producer and pipeline negotiated a new contract to replace a contract expiring by its own terms, deliveries under the new contract would be eligible for the "new" gas ceiling rate. *Area Rate for Appalachian and Illinois Basin Areas*, 48 FPC 1299, *reh. den.* 49 FPC 361 (1973), aff'd *sub nom Shell Oil Company*, 491 F.2d 82 (5th Cir. 1974).

In this case, the Commission reexamined this policy (Calco App. C-107). The Commission concluded *inter alia*, that sales under "replacement" contracts should be eligible for the new national rate to provide additional revenues for expanded exploration and development and additional dedications to the interstate market (Calco App. C-108 - C-109); a new contract negotiated by and acceptable to the purchaser was a necessary prerequisite to such eligibility (Calco App. D-43, D-45); the Commission thereby sought to assure additional commitments by the producer "in the form of additional acreage dedication, exploration and development activity on the previously dedicated acreage, or other similar activities that could result in the dedication of additional new gas supplies to the interstate market" (Calco App. D-45); and where such new contracts were negotiated, the additional revenues would provide "capital available to those entities which will explore for and develop new natural gas supplies for the interstate market" (Calco App. D-5).

The Court of Appeals' opinion reflects that these conclusions were not reached, as petitioners assert, in isolation and without reference to the extensive record. Thus, the record reflects that all parties had adequate notice and opportunity to be heard on the issue (Calco App. A-27); certain of the cost data before the Commission included then current costs of recompletions, deeper drilling, and "rejuvenating old wells to extend their productive life" (Calco App. A-10), and capital costs of recompletions (Calco App. A-11); the Commission was applying the rate "functionally" (Calco App. A-29); and the Commission had exercised its "discretion after considering all pertinent options" (Calco App. A-30).[6]

Contentions that the court below failed to canvass the record and apply proper standards of review thus are without foundation. The Commission's conclusions were supported and rationally considered, as the court held. Petitioners, in essence, simply seek to substitute their judgment for the reasoned conclusions of the Commission on questions of rate design and policy—questions which Congress entrusted to the Commission, as recognized in *Permian* and in *Mobil*.[7]

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[6] Commission use of a "functional" approach in rate design, to encourage exploration and development, was sanctioned in *Permian* (390 U.S. at 796-798) and again in *Mobil* over objections by New York strikingly similar to those now asserted here (417 U.S. at 319-321). The language of this Court in *Mobil* was similar to that of the court below in its reference to Commission rate design: "From these facts it reasoned that the national rate structure should be functionally applied to provide some of these funds, placing the burden not just on 'new' gas but also on flowing gas for which the primary contract had expired" (Calco App. A-30).

[7] A consistent fallacy in petitioners' arguments on the merits is their basic thesis that "costs" associated with "flowing gas" do not change, or are immune from inflation and rising costs. Yet, even "area rates" prescribed in the 1960s were based on cost components that are not frozen and which increase over time and declining lives of fields and reservoirs. See tabulations of cost components in *Permian Basin Area Rate Proceedings*, 34 FPC 159, 220 (1965);

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3. Petitioners contend that this component of the Commission's rate design will have a dire impact on consumers, ignored by the Commission (APGA Pet., p. 15; NYPSC Pet., pp. 13, 15, 23; AGD Pet., pp. 12-13); but, again, the decisions below refute the inflated figures and exhortations.

First, as the Court of Appeals recognized, the Commission intends to evaluate, in its biennial review of the national rate structure, whether pipelines are negotiating in good faith and whether additional funds generated are reflected in monies committed to exploration and development and volumes of new supplies (Calco App. A-30). Petitioners thus not only seek to second-guess the Commission, but also imply that the Commission cannot be trusted to do what it plainly says it will do, a proposition correctly rejected by the Court of Appeals.

Secondly, petitioners' inflated numbers run afoul of the Commission's conclusion that ". . . today's consumers should share the burden of finding replacement supplies for the supplies which are being exhausted by the consumers" (Calco App. A-30). Petitioners overlook the obvious facts that any impact of the Commission's decision over the next three to five years is dependent upon (1) how many expired contracts pipelines are willing to replace, and (2) subsequent rate orders of the Commission. Moreover, petitioners' numbers, even if valid, can be assessed only in terms of national annual sales volumes exceeding multiples of trillions of cubic feet and required annual reserve additions also exceeding multiples of trillions of cubic feet (Calco App. C-19 - C-28), annual curtailments in multiples of billions of cubic feet (Calco App. C-37 - C-40), and annual capital requirements that can

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Southern Louisiana Area Rate Proceedings, 40 FPC 530, 603 (1968); *Hugoton-Anadarko Area Rate Proceedings*, 44 FPC 761, 937 (1970).

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be expressed only in billions of dollars (Calco App. D-55).

Lastly, petitioners' implications that the Commission did not consider impact of the decision as to replacement contracts is not in accord with the record. The Commission did make a study of projected, potential impact of the overall national rate structure (Calco App. D-56). That study was based on assumptions that *included* supplies to be sold under renegotiated contracts (Calco App. D-57). For all gas eligible for the new rate, including such supplies, the Commission estimated increases in the average residential price ranging from 0.71 per cent to 1.46 per cent in the first year, and after five years, ranging between 4.03 per cent and 16.46 per cent, under a variety of alternative assumptions (Calco App. D-59). The Commission also assessed impact of curtailments on residential, commercial, and industrial consumers, and the higher costs of alternative fuels, concluding:

> "In evaluating the overall public interest, we must consider the benefits to the consumer of an incremental supply of gas to provide reliable gas service compared to the consumer detriment if natural gas supply is reduced. The increased consumer cost attributable to higher well-head gas prices is more than counter-balanced by the more probable assurance of continued service" (Calco App. D-60).

4. The decision of the Commission to allow the national rate for replacement contracts thus was reached after "reasoned consideration" of factors cited by petitioners. Affirmance by the Court of Appeals was in full accord with the record, decisions of this Court, and the functions of the Court of Appeals on questions of substantial evidence under Section 19(b) of the Act.

This question does not require or warrant review by this Court.

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III. The Decision As To Refund Credits and Contingent Escalations Under Area Rate Orders Does Not Conflict With Constructions of The Natural Gas Act By This Court

Petitioners in Nos. 75-1289 and 75-1299 contend that this case presents questions of improper "retroactive rate-making" by the Commission (Calco Pet., pp. 2-3, 5-8; Shell Pet., pp. 3, 11-15). No such questions are presented.

In four area rate decisions, the Commission adopted integrated rate structures. These structures combined rate levels, contingent escalations, formulae under which individual producers could dedicate new supplies to work off refund liabilities incurred by collection of excess amounts during the 1960s and early 1970s, and related moratoria on other rate increases.[8]

The Commission and the courts recognized that the refund-forgiveness schemes accorded preference to producers who had collected the highest rates in the past and discriminated against producers who had made refunds and collected lower rates. See *Mobil Oil Corporation* v. *FPC*, 417 U.S. 283, 321-325 (1974). Even though these benefits were "icing" on the "cake" for the beneficiaries, the Court of Appeals and this Court nevertheless concluded that the recognized inequities were not the "degree of discrimination" which would make the schemes unlawful under the standards of Section 4 of the Act (*Mobil*, 417 U.S. at 324-325).

The Commission opinions in this case left these structures intact. The Commission affords the beneficiaries who still owe refunds the option of continuing to earn credits under the refund-forgiveness formulae, or of electing to receive the new national rate for specific sales and waiving additional credits for such sales under the refund and contingent escalation formulae (Calco App.

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[8] See cases cited in fn. 4, *supra* p. 8.

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C-1, C-109 - C-110, D-64 - D-65). The Commission concluded that such treatment was "equitable," consistent with the "spirit of the area rate" decisions, and prevented "a double benefit" for the beneficiaries of those decisions (Calco App. C-110). Thus, each producer must weigh the comparative benefits individually and then choose to continue to earn the refund credits and escalations, or choose to obtain the higher national rate and waive such credits and escalations (Calco App. D-64 - D-65).

On review, the producers who apparently still owe refunds contended that such treatment constituted "improper retroactive modification" of the area rate decisions (Calco App. A-42). The Court of Appeals disagreed, holding that there was no such modification; the national rate rested upon "an independent determination of incentives"; and replacing one structure, or "providing a new alternative rate system, is an exercise of Commission discretion which does not amount to retroactive rate regulation" (Calco App. A-142).

The holding is correct and not in conflict with this Court's construction of the Natural Gas Act. Certainly, retroactive change of final rate orders is not permitted under this statute,[9] but the Commission has not violated that prohibition. The individual producer decides which of the alternative rate structures is most profitable to that producer; the option of continuing to receive all of the benefits and "iced cake" of the area rate decisions remains available; and the option of receiving the national rate is provided.

What the Commission has done thus simply is to decline to spread even more icing upon the "iced cake." The refund formulae were affirmed as a valid exercise of

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[9] See *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591, 618 (1944); *FPC* v. *Sunray DX Oil Co.*, 391 U.S. 9, 24 (1968); *Montana-Dakota Utilities Co.* v. *Public Service Co.*, 341 U.S. 246, 254 (1951).

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Commission discretion in design of a rate structure (*Mobil*, 417 U.S. at 324-326), and so too is the Commission's decision to continue that structure as an available option for those producers who still owe refunds for excess collections in the 1960s and early 1970s.[10]

Questions as to "retroactive ratemaking" therefore are not raised in this case, and there is no conflict with this Court's decisions.

CONCLUSION

For the foregoing reasons, the petitions should be denied.

Respectfully submitted,

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[10] To paraphrase this Court's observations in *Mobil*, certain producers voluntarily charged the higher rates in the 1960s and 1970s; voluntarily exercised a "business judgment" in declining to settle, reduce rates, and make refunds in those past years; and voluntarily entered into a later settlement, now embodied in the area rate decisions, to work off those refund liabilities. Now, the Commission permits further voluntary exercise of the same "business judgment": if the refund credit formulae still are more profitable, a producer can continue to receive the credits and benefits, but if the "business judgment" is that the national rate is more beneficial, the producer may elect to charge that rate and cease earning the credits (*cf. Mobil*, 417 U.S. at 324-325, 327).

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NOS. 75-1289, ET AL.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

NO. 75-1304

AMERICAN PUBLIC GAS ASSOCIATION, *Petitioner,*

v.

FEDERAL POWER COMMISSION, *Respondent.*

NO. 75-1305

PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK, *Petitioner,*

v.

FEDERAL POWER COMMISSION, *Respondent.*

NO. 75-1308

ASSOCIATED GAS DISTRIBUTORS, *Petitioner,*

v.

FEDERAL POWER COMMISSION, *Respondent.*

BRIEF OF RESPONDENT PRODUCERS IN OPPOSITION TO PETITIONS FOR WRITS OF CERTIORARI

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NO. 75-1308

ASSOCIATED GAS DISTRIBUTORS, *Petitioner*,

v.

FEDERAL POWER COMMISSION, *Respondent*.

BRIEF OF RESPONDENT PRODUCERS IN OPPOSITION TO PETITIONS FOR WRITS OF CERTIORARI

Shell Oil Company, *et al.*[1], herein called "Producers", parties to the case below and Respondents in Case Nos. 75-1304, 75-1305, and 75-1308[2], hereby submitted their

1. A complete list of the Producer Respondents joining herein is contained on the inside cover of this Brief.

2. Some of the parties joining herein are also Petitioners in Case No. 75-1299. Parties hereto take no position as to whether the Petition in Case No. 75-1289 should be granted.

Brief in Opposition to the Petitions filed in Case Nos. 75-1304, 75-1305, and 75-1308, for Writs of Certiorari to review the Opinion and Judgment of the United States Court of Appeals for the Fifth Circuit entered in this case on October 14, 1975.

STATEMENT OF POSITION

The principal question raised by Petitioners in Case Nos. 75-1304, 75-1305, and 75-1308, is whether the Commission is required by the Natural Gas Act or previous decisions of this Court to adhere to the "two-price" or "multiple vintage price" approach to producer pricing which it had adopted in the earlier area rate decisions[3], or whether it has discretion to find that this approach has failed to elicit adequate gas supplies, and should be gradually phased out.

The "phase-out" procedure, in which the Commission permits "old" gas to become "new" with reference to the ceiling price to be applied to the gas, when the initial long-term contract under which the gas was sold has expired by its terms[4], and the producer and pipeline purchaser have entered into a new contract "rededicating" the gas to the interstate market, was initially announced by the Commission in the *Appalachian Area Rate Decision*, 48 F.P.C. 1299 (1972). It was strongly attacked on appeal by the Public Service Commission of New York,

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3. *Permian Basin Area Rate Decision*, 34 F.P.C. 159, reversed, *Skelly Oil Co. v. F.P.C.*, 375 F.2d 6 (10th Cir. 1967), reversed and Commission affirmed, *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968); *Southern Louisiana Area Rate Case II*, 46 F.P.C. 86; affirmed, *Placid Oil Co. v. F.P.C.*, 483 F.2d 880 (5th Cir. 1973); affirmed, *Mobil Oil Corp. v. F.P.C.*, 417 U.S. 283 (1974).

4. Acceleration of the expiration date initially provided in the contract is not permitted under the Commission orders.

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Petitioner in Case No. 75-1305, and the Associated Gas Distributors, Petitioner in Case No. 75-1308. After hearing the same arguments raised here, the United States Court of Appeals for the Fifth Circuit affirmed the Commission in *Shell Oil Company v. F.P.C.*, 491 F.2d 82 (1974).

The Commission continued its new policy in its *Rocky Mountain Area Rate Decision*, 49 F.P.C. 924, 49 F.P.C. 1279 (1973), and in its second *Permian Basin Area Rate Decision*, 50 F.P.C. 390, 50 F.P.C. 932 (1973), appealed to the United States Court of Appeals for the Ninth Circuit, *Public Service Commission of the State of New York v. F.P.C.*, Case No. 73-3328, petition withdrawn. New York and AGD continued their challenge to the Commission's new policy, appealing various orders implementing this policy in other areas. These appeals were taken to the United States Court of Appeals for the District of Columbia Circuit, which also upheld the Commission in *Public Service Commission of New York v. F.P.C.*, ____ F.2d ____ (Case Nos. 75-1647, *et al.*, D.C. Circuit, issued January 27, 1976).

In the case below, the Commission had before it substantial evidence of the massive capital requirements of the producing industry, if that industry is to accomplish even the minimum objective of replacing natural gas supplies being currently produced. Even if the National Ceiling Rate For New Gas were high enough to constitute the necessary incentive for investment, which Producers dispute[5], it would be many years before enough gas

5. The reasons why the National Ceiling Rate is inadequate as an incentive are succinctly summarized in Commissioner Moody's dissent to Opinion No. 699, C.A. C-220-C-227.

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could be found and dedicated to substantially increase the industry's revenues, and provide needed capital.[6]

The principal source of *current* capital for gas exploration must be revenues from the sale of gas already found and in production. This method of satisfying this need for capital availability is relied upon by the Commission at various places in its opinion (C.A. D-34, 35; C.A. D-54, 55, C.A. D-75) in support of its adoption of a minimal rate of return (C.A. D-34, 35; C.A. D-75), and its refusal to give effect to other "non-cost" factors. This evidence was also relied on by the Court of Appeals in affirming the Commission on this issue (C.A. A-29).

In addition to the need for generation of capital to perform gas exploration, the Commission also had before it evidence that as a gas reservoir nears depletion, as is usually the case after the expiration of a long-term (usually 20 years) contract, additional expenditures for compression, well workovers, etc. are required to continue the gas on production. If the price is adequate, these expenditures will be made. If it is not, the wells will be abandoned and the remaining reserves lost. From the standpoint of the cost to the consumer, even allowing for an increase in the price paid the producer, this gas is less expensive than newly discovered gas supplies, be-

6. The impact of the phase-out procedure was estimated in the dissenting opinion of Commissioner Smith at 2.6 billion dollars, a figure cited in all three Petitions. This is a gross overstatement. As New York admits (p. 14), the impact has already been reduced by an increase in the ceiling price allowed all "flowing" gas in Docket No. R-478 by one-third. Commissioner Smith also failed to consider the fact that new contracts will not be immediately signed by the pipelines, delaying the application of the new ceiling. New wells drilled on renegotiated contracts would receive the new rate in any event further reducing the impact of this procedure. The overall impact of the entire rate structure was considered by the Commission (C.A. D-56 to D-62). This is all that is required.

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cause all of the pipeline facilities needed to connect the gas are already in place and must be included in the pipeline rate base, whether they are used or not.

New York (p. 17) and APGA (p. 15) insist that the premature abandonment problem be handled on an individual case-by-case basis through applications for "special relief" from the ceiling rates to the Commission, in which the producer would be required to prove that the gas could not be continued in production under the ceiling for "old" gas before a higher rate was allowed. Like the individual company cost-based rate approach condemned in *Permian*[7], an individual case-by-case approach to this problem is doomed to failure by the administrative burden and lengthy delays occasioned by the procedure.[8]

We therefore believe, as did the Court of Appeals (C.A. A-31), that the Commission had substantial evidence in the record, and sufficient discretion and authority under the Act and decisions of this Court and those of various Courts of Appeals, to modify and "phase out" the multiple vintage price system.

APGA raised two additional questions, one of which has already been resolved by the courts adversely to their position, and the other of which amounts to a choice of various alternative costing methods which is clearly within the Commission's discretion.[9] We will briefly discuss why

7. *Permian Basin Area Rate Cases*, 390 U.S. 747, 757.

8. It is also noteworthy that in the few cases where this approach has been attempted, it has been reversed by the Courts, see *Macdonald v. F.P.C.*, 505 F.2d 335 (D.C. Cir. 1974); *Cities of Fulton, et al. v. F.P.C.*, 512 F.2d 947 (D.C. Cir. 1975).

9. The questions raised as to the amount of liquid credit and the credibility of the reserves estimate are clearly matters within the Commission's discretion and do not require review here.

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these questions also do not warrant this Court's consideration.

REASONS FOR DENYING THE PETITIONS FOR WRITS IN CASE NOS. 75-1304, 75-1305, AND 75-1308

I. The Questions Raised By These Petitions Do Not Fall Within The Standards Of Review Laid Down By This Court.

In *Mobil Oil Corp. v. F.P.C.*, 417 U.S. 283 (1974), this Court reiterated and amplified the standards of review of Federal Power Commission Orders laid down in *F.P.C. v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), and *Permian Basin Area Rate Cases*, 390 U.S. 747, at 767 (1968). The Commission was given broad discretion to select modes of regulation, which would not be overturned by the courts unless they lacked support by substantial evidence, or unless the Commission had exceeded or abused its authority. Here the Commission has made a determination, repeated in three area rate decisions, innumerable specific orders, and the major national rate decision here under review, that the two-price system initially adopted as an experiment in *Permian* was theoretically unsound (C.A. D-54, 55) and has dramatically failed to produce adequate supplies of natural gas for the consumers of this nation (C.A. C-19 to C-29). The Commission therefore decided to gradually eliminate the multiple vintage price system by allowing gas in the latter stage of the depletion process (the time when additional expenditures may expand reserves by deferring the abandonment date) to be priced at the ceiling rate for "new" gas. Over a period of years the "vintaging" of gas

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prices will gradually disappear (Court of Appeals opinion, C.A. A-31), thus minimizing the impact on the consumer. This type of policy decision is discretionary with the Commission; thus, under *Mobil, supra* (417 U.S. 283, 308), the Court should not "supplant" the Commission's decision. *Mobil* further teaches that the review of the Commission's decision is the primary function of the Court of Appeals, and

> "'. . . This Court will intervene only in what ought to be the rare instance where the standard appears to be misapprehended or grossly misapplied.' Universal Camera Corp. v. NLRB, 340 U.S. 474, 491." (417 U.S. 283, 310)

The Court of Appeals thoroughly reviewed the Commission's action utilizing the *Mobil* standards (C.A. A-28 to A-31). No further action is required by this Court.

II. The Commission's Decision To Abolish Vintaging Is Soundly Based, Both In Theory And In Substantial Record Evidence.

A. The Two-Price System Has Failed.

The Commission's Opinion below points out at length the developing shortage of natural gas in the United States, and the manifest failure of the *Permian* method of regulation to cope with the growing shortage (C.A. C-19 to C-43). The basic reason for the failure, discussed in depth in the concurring and dissenting opinion of Commissioner Moody (C.A. C-169 to C-229), is that in a period of inflation and increasing costs, holding the bulk of the nation's gas supply to rates which are based upon the estimated *original* cost of developing these reserves

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will not provide the capital required to replace those reserves with new supplies. It is the view of the Producers that the Commission has failed to recognize that its cost-based rate is too low, both in the manner of its calculation, and as judged by external market tests. In so doing, it has created a ceiling rate which is much too low to provide even future incentives to resolve the gas shortage. This is tacitly admitted by Petitioners, who urge that the producers will not recommit the capital obtained by the abolition of the vintaging policy to further gas exploration unless the funds are earmarked, and their use policed, by the Commission (New York, p. 17; AGD, p. 9; APGA, p. 15). If the Commission's ceiling price is what it is statutorily required to be, and will provide a return sufficient to attract investment (*Permian*, 390 U.S. 747, 796), then such earmarking and policing are not required.

The Commission has treated the inclusion of a portion of the gas already flowing in the "new" gas vintage ceiling as a "non-cost" factor to provide additional capital to the industry which cannot be provided by the ceiling price for future gas, no matter what the level of that price may be. In addition, it has imposed the serious requirement that the purchasing pipeline company must sign a new contract before the new vintage price will apply. As The Superior Oil Company pointed out to the Court of Appeals, the pipeline is in a vastly superior bargaining position, as the gas must continue to be sold to it unless and until the Commission permits abandonment (see *Sunray Mid-Continent Oil Co. v. F.P.C.*, 364 U.S. 137 (1959). The producer must provide some new consideration to the pipeline before the pipeline will renegotiate the contract, where the only effect of the renegotiation is to permit the application of a higher ceiling price. Con-

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trary to the allegations of Petitioners, the pipelines *have* required further consideration, such as, commitment of additional new reserves, further exploration or development expenditures, before entering into "renegotiated" contracts.

In *Mobil, supra,* this Court specifically approved the new Commission policy of placing part of the burden of expanding gas exploration on all users of natural gas, rather than on those alone who purchase gas in the future (417 U.S. 283, 320). The current Commission decision represents a permissible expansion of this policy.

B. The Two-Price System Has Always Been Theoretically Unsound And Discriminatory.

Although this Court in *Permian* approved the use of the two-price system on an "experimental" basis, it did so as a proper use of the Commission's discretion, not on any mandatory basis, see *Permian,* 390 U.S. 747, 797-98.

The theory of the two-price system was sharply criticized by the Court of Appeals for the Fifth Circuit in *Placid Oil Co. v. F.P.C.,* 483 F.2d 880, 899-900 (1973). That Court discussed the logical inconsistency of arbitrarily distinguishing an indistinguishable commodity by date of contract (see 488 F.2d at 890). This Court approved the Fifth Circuit's reasoning in *Placid* in its *Mobil* decision, *supra,* specifically rejecting arguments made by New York, one of the Petitioners here (No. 75-1305) that the entire burden of the cost of finding new gas supplies must be placed on the consumers of those supplies, and not on existing users, see 417 U.S. at 320.

The Commission has already substantially departed from the *Permian* two-price system prior to this case. In

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Opinion No. 567, 42 F.P.C. 727 (1969), the Commission provided that new reservoirs discovered under "old" vintage contracts should receive the "new" vintage price where the date of discovery of the reservoir was "new" vintage. In another part of the Opinion below (C.A. C-154, C-155), the Commission included under the "new" gas ceiling price wells commenced on previously contracted acreage, where the well was commenced in the "new" vintage time period. This part of the Opinion is not challenged by Petitioners. Yet these are similar efforts by the Commission to phase out the "anachronistic" (*Appalachian Area Rate Decision,* 48 F.P.C. 1299, 1309, affirmed, *Shell Oil Co. v. F.P.C.,* 491 F.2d 32 (5th Cir. 1974)) multiple vintage price system.

III. The Other Questions Raised By The American Public Gas Association Do Not Merit Consideration By This Court.

A. The Commission's Power To Establish Rates By Rulemaking Has Been Affirmed By Three Circuit Courts of Appeals, Following *United States v. Florida East Coast Railway.*[10]

The American Public Gas Association's attack on the power of the Commission has been unanimously rejected in all of the courts where it has been raised, and the courts have held that the formal hearing processes of the Administrative Procedure Act are not required, see *Phillips Petroleum Co. v. F.P.C.,* 475 F.2d 842 (10th Cir. 1973), *cert. denied, sub nom. Chevron Oil Co. v. F.P.C.,* 414 U.S. 1146 (1974); *American Public Gas Association*

10. 410 U.S. 224 (1973).

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v. F.P.C., 498 F.2d 718 (D.C. Cir. 1974); *United States v. Florida East Coast Ry.*, 410 U.S. 224, 246 (1973).

Far from being contrary to the decision of the Court of Appeals below, as alleged by APGA (p. 8), the decision of the District of Columbia Circuit in *Mobil Oil Corp. v. F.P.C.*, 483 F.2d 1238 (1973) is completely consistent with the Commission's actions here and the decision below of the Fifth Circuit. The D. C. Circuit *declined* to hold that the Commission was required to follow the procedures set out in Sections 556 and 557 of the Administrative Procedure Act (see 483 F.2d at 1250, 1253-54). The D.C. Circuit required only that each party be given ample opportunity to criticize and attack contrary positions taken by other parties (see 483 F.2d at 1258). This the Commission did in the proceedings below (C.A. C-14 to C-18, D-6, 7).

The Court of Appeals below thoroughly considered APGA's arguments and found that all procedural requirements of the Natural Gas Act and Administrative Procedure Act had been satisfied (C.A. A-23 to A-27). No review is required by this Court.

B. The Commission Has Discretion To Adopt The DCF Costing Method On Rehearing.

APGA is the only Petitioner contending that the Commission's adoption of the discounted cash flow ("DCF") costing methodology is not within the Commission's discretion. APGA's argument is without merit for three reasons.

First, substantial record evidence warranted adoption of DCF costing methodology. Dr. Ezra Solomon presented

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extensive testimony demonstrating that this is the only methodology the Commission could use to accurately state anticipated rate of return on capital investment since this is the only methodology which takes into account receipts on investment relative to time of outlay, that is, the time value of money. Mr. Robert H. Park submitted testimony illustrating an actual DCF format.

Second, in approving the Commission's choice of the DCF methodology, the Court pointedly stated that:

> "Without delving into the complexities of an esoteric costing methodology which counsel could scarcely describe in their briefs or at oral argument, we need only note that a reviewing court would go far afield in striking down an analytical model adopted by the Commission." (C.A. A-36)

The selection between the various types of costing methodology lies within the Commission's discretion, see *Permian* (390 U.S. 747, 776-77).

Third, the Court of Appeals correctly ruled that Petitioners in the case below failed to demonstrate that use of DCF methodology produced an unjust and unreasonable end result.

No new arguments against use of DCF methodology have been raised in Petitions to this Court. The Court of Appeals correctly decided that no grounds exist for striking down the DCF methodology employed by the Commission in this proceeding.

CONCLUSION

None of the questions raised in Case Nos. 75-1304, 75-1305, and 75-1308 invoke review by this Court under the standards of *Mobil*. The gradual elimination of the

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"vintage" price system, an experiment which was theoretically wrong and has manifestly failed, is long overdue. These Petitions for Certiorari should be denied.

Respectfully submitted,

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In the Supreme Court of the United States

OCTOBER TERM, 1975

NOS. 75-1289, 75-1299,
75-1304, 75-1305,
75-1308, and 75-1474

THE CALIFORNIA COMPANY, ET AL., PETITIONERS

v.

FEDERAL POWER COMMISSION

ON PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE FEDERAL POWER COMMISSION IN OPPOSITION

QUESTIONS PRESENTED

1. Whether the rulemaking procedures followed by the Federal Power Commission in establishing a nationwide ceiling rate for new sales of natural gas satisfied the requirements of the Natural Gas Act and the Administrative Procedure Act.

2. Whether the court of appeals applied the correct standard of review in affirming the Federal Power Commission's orders.

3. Whether the Federal Power Commission properly determined that the national rate may be applied to ongoing sales of natural gas if the original contract

expires of its own terms, a renewal contract is executed, and one of those events occurs on or after January 1, 1973.

4. Whether the Federal Power Commission correctly determined that natural gas sold at the national rate could not be used to discharge refund obligations or trigger contingent escalations under the incentive provisions of prior area rate orders.

5. Whether the cost methodology employed by the Federal Power Commission is reasonable and supported by substantial evidence.

STATEMENT

1. On April 11, 1973, the Federal Power Commission commenced by public notice a rulemaking proceeding to establish the maximum just and reasonable rates for jurisdictional sales of natural gas on a nationwide basis (38 Fed. Reg. 10014). The single uniform rate was to apply to all jurisdictional sales of natural gas produced from wells commenced on or after January 1, 1973. The notice made all large producers respondents to the ratemaking proceeding, provided for the submission of sworn written comments from all interested parties as well as the named respondents, and was accompanied by a staff study on the estimated nationwide cost of finding and producing new natural gas supplies. In the notice, the Commission did not propose any specific rate, terms, or conditions and stated that it would rely instead upon the information contained in the responses submitted by the various parties and the staff study.[1]

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[1]On March 21, 1974, the original notice of rulemaking was supplemented by the issuance of a revised notice in which staff cost estimates were updated to reflect 1972 data concerning drilling costs and reserve additions (39 Fed. Reg. 11310). The study indicated that the American Gas Association (AGA) reserve additions

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Following the receipt of extensive initial and reply comments and evidentiary presentations, the Commission, on June 21, 1974, issued Opinion No. 699 (Pet. App. C), establishing a new national rate structure for producer sales that was designed to alleviate the increasingly critical gas supply shortage while maintaining reasonable prices (*id.* at C120). The salient features of the rate structure were:

1. A base rate of 42.0¢ per Mcf (with annual escalations of 1.0¢ per Mcf) subject to various adjustments.

2. A biennial review to prescribe prospective just and reasonable rates for those sales that qualify for the national rate.

3. Provisions for special relief from the national rate.

The base rate would apply to three classes of sales:

1. Sales made from wells commenced on or after January 1, 1973.

2. Sales made pursuant to a contract executed on or after January 1, 1973, for the sale of gas in interstate commerce, if the gas has not previously been sold in interstate commerce except under short-term or emergency sales procedures of the Commission's regulations.

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for 1971 and 1972 might have been understated by approximately 1.7 trillion cubic feet. Since the AGA data had played an important role in the Commission's cost analysis, comments were invited concerning this apparent disparity. A public conference was held, and the AGA was unable to refute the staff's finding. The Commission's cost analysis therefore included the finding that "the reserve additions as reported by the AGA for 1971 and 1972 are understated by approximately 1.7 Tcf" (Pet. App. C55-C56).

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> 3. Sales made pursuant to a renewal contract, if the sales were formerly made pursuant to a permanent certificate of unlimited duration under a contract that expired by its own terms, and if either the renewal contract was executed or the original contract expired on or after January 1, 1973.[2]

As part of the total rate structure the Commission also determined that natural gas sold at the new national rate could not be used to discharge refund obligations or to trigger contingent escalations under the incentive provisions of its orders in four prior area rate proceedings (Pet. App. C109-C111). Rather, producers who elect to discharge their existing refund obligations or who desire to obtain the contingent escalations for flowing gas under these prior area rate orders will be required to price the flowing gas at the rate established in the area rate orders. The Commission found this treatment "equitable since the rates established in those opinions were determined to be sufficient to encourage exploration and development activities when coupled with the [incentives]" (*id.* at C110). It stated that "[t]o allow producers to collect the [national] rate * * * and to discharge their existing obligations * * * with the same supplies of natural gas would be contrary to the spirit of the applicable area rate opinion" and would allow

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[2]This statement of the third sales category, the so-called "renewal contract" provision, encompasses later amendments to the original order. As originally stated, the category was limited to renewal contracts executed on or after January 1, 1973, which replaced contracts expiring on or after that date. The provision was later amended to include renewal contracts executed on or after January 1, 1973, even if the primary contract expired prior to that date (Opinion No. 699-A). The provision was amended further to include renewal contracts executed prior to Janaury 1, 1973, to replace primary contracts expired or expiring on or after that date (Pet. App. D43-D45).

producers to "receive a double benefit from the rate structure which we establish in this decision" (*ibid.*).

Subsequently, in Opinion No. 699-H, the Commission increased the rate ceiling for "new gas" sales from 43.0¢ to 50.0¢ per Mcf, following a supplemental cost analysis "to assure that the rate allowed for new gas supplies adequately reflects the true cost of those supplies" (Pet. App. D15).

2. On petitions for review, the court of appeals affirmed the Commission's orders (Pet. App. A). The court ruled that the Commission could properly establish a national rate for new sales of gas by rulemaking without "adversarial trial procedures such as formal evidentiary hearings, oral testimony, and oral cross-examination" (*id.* at A23). "The procedures used in setting the national rate neither prejudiced [the participants], nor prevented a full and true disclosure of the facts" (*id.* at A25). In "an undertaking so massive and novel as setting a national rate for new gas, the proceeding would have taken years, and the Commission's power to effectively regulate the industry would have been destroyed," if the Commission had "allowed all interested parties to submit oral testimony and conduct oral cross-examination" (*id.* at A26-27).

The court also rejected each of the other attacks on the order that are reiterated in the present petitions:

(a) The Commission's cost methodology was attacked from both sides, some parties claiming that it led to a national rate for new gas that was inadequate to generate capital for future exploration and others contending that the resulting rate was too high. The court of appeals, however, approved the Commission's cost-based methodology and concluded that the national rate

was within the zone of reasonableness accorded by reviewing courts to Commission action (*id.* at A31-A41).[3]

(b) The court also sustained the application of the new national rate to certain renewal contracts replacing old contracts for flowing gas. The court held (*id.* at A28-A30) that the Commission could properly make the rate for flowing gas bear part of the cost burden of financing added exploration. "The Commission found from evidence in the record that a massive commitment of new funds is necessary to alleviate the natural gas shortage and that internally generated sums are a necessary source of such funds" (*id.* at A29). The court therefore upheld the Commission's determination "that the national rate structure should be functionally applied to provide some of these funds, placing the burden not just on 'new' gas but also on flowing gas for which the primary contract had expired" (*id.* at A30).

(c) Finally, the court of appeals sustained the Commission's determination that natural gas sold at the national rate could not be used to discharge refund obligations or to trigger contingent escalations (*id.* at A41-A42). The court held that this feature of the new national rate did not constitute "an improper retro-

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[3]The Commission's cost analysis was based upon the methodology developed in the first *Permian Basin Area Rate Proceeding*, 34 F.P.C. 159. The Commission found that the record evidence supported a range of reasonable costs, and it selected a rate within the range of rates supported by those costs that "will provide the incentive necessary to encourage producers to undertake expanded exploration and development programs and to dedicate the natural gas discovered and produced as a result of those programs to the interstate market" (Pet. App. C120). In a departure from the *Permian* methodology, the Commission also employed a discounted cash-flow model in evaluating its cost findings "to assure that the rate allowed for new gas supplies adequately reflects the true cost of those supplies" (Pet. App. D15).

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active modification of prior rate opinions" (*id.* at A42). "The new national rate is the product of an independent determination of incentives, and, as it is in so many other regards, the new rate structure is not tied to previous determinations. Replacing one incentive structure with another or, viewed in another light, providing a new alternative rate system, is an exercise of Commission discretion which does not amount to retroactive rate regulation" (*ibid.*).

ARGUMENT

The contentions raised in the petitions were carefully reviewed and correctly rejected by the court of appeals; further review by this Court is not warranted.

1. Petitioner American Public Gas Association (APGA) (Pet. No. 75-1304, pp. 6-11) contends that the Commission's use of a rulemaking process to establish the national rate violated both the Natural Gas Act and the Administrative Procedure Act. APGA argues that the Commission erred in failing to follow in these rate proceedings the formal hearing procedures of 5 U.S.C. 556 and 557. But those procedures—requiring a full evidentiary hearing before a hearing officer, an initial decision, and review by the Commission—are required for rulemaking only "[w]hen rules are required by statute to be made on the record after opportunity for an agency hearing" (5 U.S.C. 553(c)). Therefore, "Sections 556 and 557 need be applied 'only where the agency statute, in addition to providing a hearing, prescribes explicitly that it be 'on the record'" *United States* v. *Allegheny-Ludlum Steel Corp.*, 406 U.S. 742, 757. This principle applies to agency ratemaking. *United States* v. *Florida East Coast Railway Co.*, 410 U.S. 224. Since neither the ratemaking provisions of the Natural

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Gas Act (15 U.S.C. 717c, 717d) nor the rulemaking provision (15 U.S.C. 717o) requires a hearing "on the record," the formal hearing procedures of the Administrative Procedure Act are not required in the Commission's ratemaking.

APGA contends, however, that the provision in 15 U.S.C. 717r(b), making the Commission's findings conclusive if supported by substantial evidence, is the equivalent of an "on the record" requirement (Pet. No. 75-1304, p. 7). Concededly the precise words "on the record" are "not words of art, and * * *other statutory language having the same meaning could trigger the provisions of §§556 and 557 in ratemaking proceedings" *(Florida East Coast Railway Co., supra,* 410 U.S. at 238). But the three courts of appeals that have addressed the issue, including the court of appeals in this case, have uniformly concluded that neither the express provisions of the Natural Gas Act nor their legislative history requires a formal evidentiary hearing in Federal Power Commission ratemaking proceedings. *Mobil Oil Corp.* v. *Federal Power Commission,* 483 F.2d 1238 (C.A. D.C.); *American Public Gas Association* v. *Federal Power Commission,* 498 F.2d 718 (C.A. D.C.); *Phillips Petroleum Co.* v. *Federal Power Commission,* 475 F.2d 842 (C.A. 10), certiorari denied *sub nom. Chevron Oil Co.* v. *Federal Power Commission,* 414 U.S. 1146.

In any event, the words "substantial evidence" as used in 15 U.S.C. 717r(b) add nothing to the "after a hearing" language of 15 U.S.C. 717d(a), which by itself is insufficient to trigger the formal hearing requirements. *Allegheny Ludlum Steel Corp., supra.* When viewed in light of 15 U.S.C. 717n(b), which states that "[n]o informality in any hearing, investigation, or proceeding or in the manner of taking testimony shall invalidate any order, decision, rule, or regulation," the language

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of 15 U.S.C. 717r(b) does not amount to an "on the record" requirement that would invoke the formal procedures of 5 U.S.C. 556 and 557.[4]

Finally, the decision below does not conflict with the District of Columbia Circuit's decision in *Mobil Oil Corp.* v. *Federal Power Commission, supra.* In *Mobil* the court held that, although a formal evidentiary hearing is not required for ratemaking, the less rigorous informal rulemaking standards of 5 U.S.C. 553 were insufficient. The court below, however, found that it was "unnecessary to enter the colloquy" between the *Mobil* court and other courts concerning the minimum procedures required for ratemaking, because the procedures followed by the Commission "went beyond the rudiments of informal rulemaking"(Pet. App. A23, A24).[5] Indeed, the court concluded that the procedures followed by the Commission

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[4]Even when a statute requires that the rulemaking procedure take place "on the record after opportunity for an agency hearing," thus making Section 556 applicable, subsection (d) of that section provides that the agency may proceed by the submission of all or part of the evidence in written form if a party will not be "prejudiced thereby." As the court below correctly held (Pet. App. A25), "[t]he procedures used in setting the national rate neither prejudiced the APGA, nor prevented a full and true disclosure of the facts."

[5]The promulgation of the national rate was preceded by a notice which "clearly indicated that the Commission intended to establish by rule nationwide rates for natural gas " (Pet. App. A23) and "provided for the submission of sworn written comments" (*id.* at A24). More than 80 parties "representing a broad range of consumer and gas industry interests" submitted "sworn testimony and evidentiary data" and were given the opportunity on a second round of submittals to "rebut both Commission and privately-generated evidence" (*ibid.*). Additionally, the Commission held a public conference on the issues concerning possible under-reporting of reserve additions and drilling footages and held two days of oral argument on its proposed orders (*ibid.*; see n. 1, pp. 2-3, *supra.*

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"satisfie[d] even the more stringent requirements of the formal hearing process" (*id.* at A25). Thus, the question of what minimum procedures are necessary for ratemaking by rulemaking under the Natural Gas Act and the Administrative Procedure Act—the question before the District of Columbia Circuit in *Mobil*—is not present in this case.[6]

2. Petitioners Associated Gas Distributors (Pet. No. 75-1308, pp. 6-12) and American Public Gas Association (Pet. No. 75-1304, pp. 11-14) contend that the court of appeals applied an incorrect standard in reviewing the Commission's orders. There is no merit to the contention.

In *Permian Basin Area Rate Cases*, 390 U.S. 747, 791-792, this Court held that the responsibilities of a reviewing court were to determine (1) whether the Commission had abused or exceeded its authority; (2) whether each of the order's essential elements is supported by substantial evidence; and (3) whether the order may be expected to "maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable." Further, the "court's responsibility is not to supplant the Commission's balance of these interests with one more nearly to its liking, but instead to assure itself

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[6]APGA is incorrect in suggesting that Section 1.20(g) of the Commission's regulations, 18 C.F.R. 1.20(g), requires a formal evidentiary hearing (Pet. No. 75-1304, p. 10). Section 1.20(g) governs the "presentation by the parties" when, and if, the Commission determines that a formal hearing is necessary and when it initiates such a hearing pursuant to Section 1.20(a), 18 C.F.R. 1.20(a). Section 1.20(m), 18 C.F.R. 1.20(m), sets forth the procedures to be utilized in rulemaking. Thus, Section 1.20 merely allows the Commission to implement its broad authority to tailor procedures to the needs of particular cases and cannot properly be construed to require the Commission to hold a formal hearing.

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that the Commission has given reasoned consideration to each of the pertinent factors" (*id.* at 792). The Commission's orders are, therefore, entitled to a "presumption of validity," and those who would seek to overturn the orders bear "the heavy burden" of showing that the order is "unjust and unreasonable in its consequences" (*id.* at 767).

In *Mobil Oil Corp.* v. *Federal Power Commission*, 417 U.S. 283, this Court emphasized that "application of the three criteria of judicial review of Commission orders is primarily the task of the courts of appeals"; that the "responsibility to assess the record to determine whether agency findings are supported by substantial evidence" is, by virtue of Section 19(b) of the Act (15 U.S.C. 717r(b)) the function of the court of appeals; and that this Court therefore will intervene only in the "rare instance when the standard appears to have been misapprehended or grossly misapplied" (417 U.S. at 309-310).

No such "rare instance" is presented here. The court of appeals correctly apprehended and properly applied the review standards enunciated by this Court in *Permian*. The ultimate issue for the court was whether the "end result" of the order was "unjust and unreasonable," and it resolved that issue by applying the criteria established by this Court in *Permian* (Pet. App. A15-A16). The court was "guided by four elements which delimit the scope of our authority" (Pet. App. A15):

> (i) the well-known statutory "substantial evidence" standard, (ii) a judicially recognized "presumption of validity" * * *, (iii) the longstanding "total effect" test of *FPC* v. *Hope Natural Gas Co.*, 1944, 320 U.S. 591, * * * and (iv) a "zone of reasonableness" to compensate for the necessarily imprecise nature of cost determinations and the inherent difficulty of the regulatory undertaking.

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The court indicated, however, that its "narrow scope of review" was further "tempered" by the experimental nature of area and national rate regulation, which calls for a "heightened deference to the Commission's expertise" (*id.* at A16-A17).

Applying the *Permian* review criteria to each element of the Commission's order, the court of appeals found that the Commission was authorized to prescribe a "national" rate for new gas sales (*id.* at A20-A23) and that each element of the national rate structure—specific cost findings and methodology—was reasonable and supported by substantial evidence (*id.* at A27-A44).[7] Petitioners argue that the court incorrectly afforded the Commission's orders too

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[7]The court below rejected several attacks upon the Commission's cost-based formula raised here by petitioners APGA (Pet. No. 75-1304, pp. 12-14) and Shell Oil Company (Pet. No. 75-1299, pp. 8-11, 15-21): (1) the court found that the Commission's analysis of the evidence leading to a future productivity (the amount of natural gas added to the non-associated gas reserves for every foot drilled) was "supported by the record" (Pet. App. A31-A35); (2) the court found that the parties who had attacked the Commission's use of a discounted cash flow methodology as a supplementary cost analysis had "failed to sustain" their "weighty burden of proof" that the use of such methodology "results in an unjust and unreasonable end result" (*id.* at A37); (3) the court also found the Commission's "policy choice" of excluding an average federal income tax component from the national rate structure, in favor of allowing individual producers to seek extraordinary relief in the form of higher rates when they could demonstrate an "actual income tax liability," was not "so unjust and unreasonable" as to require judicial intervention (*id.* at A37-A39); (4) the court found that the Commission's projections of future lease acquisition costs "are based on substantial evidence and cannot be reversed at this stage" (*id.* at A40); (5) the court additionally held that the Commission's findings regarding the level of the net liquid credit, "a cost equation component of relatively little import," were sufficiently supported by the record (*id.* at A41); and (6) the court held that the Commission did not err in using cost-based ratemaking and in refusing to consider non-cost factors created solely by market forces (*id.* at A44-A45).

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limited a review. However, while the "experimental nature" of national rate regulation may have resulted in "heightened deference" to the Commission's expertise, the court below scrupulously examined each element of the Commission's order. Furthermore, this "deference" to Commission expertise in ratemaking orders was a central aspect of this Court's review in both *Permian, supra,* 390 U.S. at 767, 790-792, and *Mobil, supra,* 417 U.S. at 331. The court of appeals correctly concluded that such deference was appropriate here as well, because "national rate regulation is still experimental" (Pet. App. A17).

3. Several petitioners[8] contend that the decision to apply the new national rate to certain renewal contracts for flowing gas was not supported by the record and improperly failed to require recipients to engage in exploration and development. These arguments were correctly rejected by the court of appeals.

(a) Petitioners argue that there is no evidentiary basis to support the allowance of the national rate for sales under new contracts replacing long-term contracts that have expired by their own terms.[9] But the court below found (Pet. App. A29-A30):

> The Commission found from the evidence in the record that a massive commitment of new funds is necessary to alleviate the natural gas shortage and that internally generated sums are a necessary source of such funds. * * * From these facts it reasoned that the national rate structure should be functionally applied to provide some of these funds, placing the burden not

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[8] Public Service Commission of New York (Pet. No. 75-1305, *passim*); Associated Gas Distributors (Pet. No. 75-1308, pp. 6-14); APGA (Pet. No. 75-1304, pp. 14-16).

[9] The Commission found a gross disparity between supply and demand and explained that, if the nation's future need for natural

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just on "new" gas but also on flowing gas for which the primary contract had expired.

Petitioners have not shown that the court of appeals has "misapprehended or grossly misapplied" the substantial evidence standard. *Mobil, supra,* 417 U.S. at 310. Moreover, the Commission's use of price functionally to encourage exploration and development, and specifically its determination that the burden of future exploration and development should be borne in part by consumers of flowing gas, were upheld by this Court in *Mobil, supra,* 417 U.S. at 319-321. The specific mechanism chosen by the Commission to accomplish that end in the national rate case—applying the national rate to certain renewal contracts for flowing gas—has been sanctioned by the two courts of appeals that have previously addressed the issue. *Shell Oil Co.* v. *Federal Power Commission,* 491 F.2d 82 (C.A. 5); *Public Service Commission for the State of New York* v. *Federal Power Commission,* C.A. D.C., Nos. 73-1647, *et al.,* decided January 27, 1976, pending on petitions for certiorari, Nos. 75-1556, 75-1565.

(b) Petitioners suggest that even if it is permissible to increase the rate for flowing gas, the Commission erred in not requiring the producers receiving the rate increase to engage in exploration and development. The Commission determined that imposing a specific exploration and development commitment as a condition of a rate increase in replacement contracts was not neces-

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gas was to be satisfied, massive capital commitments were necessary to expand programs of exploration and development (Pet. App. C26-C28). It found that, but for the generation of internal capital through rate relief, the essential expansion of exploration and development would not take place (*id.* at D55-D56). The Commission acknowledged the impact upon the consumer in terms of the increased price of gas supplies (*id.* at D56-D62), but it concluded that the increased consumer cost attributable to higher well-head gas prices was more than counterbalanced by the greater assurance of continued service (*id.* at D60).

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sary, believing instead "that by requiring an old contract to be renegotiated before the new rate is recoverable, the pipeline might be able to negotiate for additional acreage dedication to interstate commerce, or exploration and development activity on previously dedicated acreage or other concessions for the price increase" (Pet. App. A29). Petitioners argue that in a time of natural gas shortage the pipeline negotiating a replacement contract will not be in a position to bargain for any increased gas supplies for the interstate market. In essence, petitioners seek to substitute their judgment for that of the Commission, but they have not carried their "heavy burden of making a convincing showing that [the Commission's judgment] is invalid because it is unjust and unreasonable in its consequences." *Mobil, supra,* 417 U.S. at 307, quoting *Federal Power Commission* v. *Hope Natural Gas Co.,* 320 U.S. 591, 602. As the court below correctly concluded, "the Commission has exercised its discretion after considering all pertinent options" and has "reached a well-considered, expert decision on this issue" (Pet. App. A29).

(c) In contrast to the consumer petitioners, Superior Oil Company (Pet. No. 75-1474, pp. 8-17) argues that it was illegal and arbitrary for the Commission to require a newly executed sales contract as a condition of receiving the national rate. Superior contends that the Commission lacks the authority to compel a producer and a pipeline to enter into a contract (*id.* at 10). But the Commission has not required the execution of a contract; nor has it dictated the terms of a contract if one is entered into. Under the Commission's order, the parties remain free to contract or not to contract and to determine the terms of their service contracts. Cf. *Federal Power Commission* v. *Sierra Pacific Power Co.,* 350 U.S. 348; *United Gas Pipe Line Co.* v.

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Mobile Gas Service Corp., 350 U.S. 332. The Commission has simply determined that, if a replacement contract is executed, the newly-prescribed national rate should be applicable because of the possibility that the pipeline may be able to bargain for additional acreage dedication, increased exploration and development activity, or other concessions for the rate increase. However, if the national rate were allowed with or without a new contract, a producer would be released from any obligation to bargain with a pipeline, thus eliminating any possibility of a *quid pro quo* for the rate increase.[10]

4. The Commission required producers, as a condition of receiving the national rate for "new gas," to waive their right to utilize such gas to discharge refund obligations and trigger contingent escalations under the incentive provisions of prior area rate orders. Shell Oil Company (Pet. No. 75-1299, pp. 11-15), California Company (Pet. No. 75-1289, *passim*), and Superior Oil Company (Pet. No. 75-1474, pp. 18-25) contend that this requirement is an illegal retroactive modification of prior rate orders.

However, by determining that gas sold at the national rate level cannot be used to take advantage of certain

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[10]Arguments that the requirement of a replacement contract is anticompetitive (Pet. No. 75-1474, pp. 15-17) and unduly discriminatory (*id.* at 17-18) are unfounded. There is no evidence in the record to support these assertions. Furthermore, the objections are premature. As the court below recognized, the Commission has "expressly reserved for consideration in the biennial review the question of whether the pipelines are negotiating in good faith or trying to take advantage of the producer's locked-in position, and whether or not the additional funds generated by the application of the new rate increase 'the level of monies committed to exploration and development programs and the volumes of new gas supplies dedicated to interstate pipelines under long-term contracts' " (Pet. App. A30).

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incentive provisions in prior rate orders, the Commission did not retroactively modify those orders. To the contrary, the incentive features of those orders are still operative. Each producer has a choice. He may sell his gas under the national rate structure without refund discharges and contingent escalations, or he may continue to sell at the rates prescribed in the area rate orders and avail himself of the refund discharge and contingent escalation provisions of those orders. In other words, the Commission has done nothing more than provide producers with a new alternative rate system which, as the court below correctly found, "is an exercise of Commission discretion which does not amount to retroactive rate regulation" (Pet. App. A42).[11]

Furthermore, the incentive provisions in the prior area rate orders were designed to operate in conjunction with the prescribed base *area* rate levels. As the Commission said, "the rates established in those opinions were determined to be sufficient to encourage exploration and

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[11]An identical disposition was reached by the United States Court of Appeals for the District of Columbia Circuit in *Moss* v. *Federal Power Commission*, 502 F.2d 461 (C.A. D.C.), reversed on other grounds, No. 74-883, decided March 3, 1976. The court of appeals reviewed the Commission's optional certificate procedure and upheld the provision under which a producer who obtains an optional certificate must waive his right to benefit from any contingent escalations or refund discharges that might be triggered in the area in which his sale under the optional procedure is made. The producers in that case argued, as do the petitioners here, that they were entitled to benefit from the previously established incentives *and* to sell their gas in excess of the area ceiling rate pursuant to the optional certificate procedure. The court there reasoned that in prescribing the optional procedure the Commission had provided an alternative for each producer: "[h]e may dedicate his new gas under the procedure that is most beneficial to him. * * * He may benefit under one procedure but not under both" (502 F.2d at 470). Similarly, under the orders here, a producer may sell his gas at the national rate without the incentives, or at the area rate with the incentives, but not both.

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development activities when coupled with the refund credit incentives and contingent escalations" (Pet. App. C110). To allow new dedications of gas to receive the national rate and, at the same time, discharge refund obligations or trigger contingent escalations would therefore be "an apostasy of the Commission's area rate opinions which adopted the contingent escalations and refund credits as part of a rate structure which included the then prevailing area rates for flowing gas and new gas" (Pet. App. D65).

CONCLUSION

The petitions for a writ of certiorari should be denied.

Respectfully submitted.

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OCTOBER TERM, 1975

No. 75-1305

PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK,
Petitioner,

v.

FEDERAL POWER COMMISSION,
Respondent.

REPLY OF THE PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK TO BRIEF IN OPPOSITION OF THE FEDERAL POWER COMMISSION

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REPLY OF THE PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK TO BRIEF IN OPPOSITION OF THE FEDERAL POWER COMMISSION

The petition for a writ of certiorari filed in this case by the Public Service Commission of the State of New York ("New York"), like the petition filed in Case No. 75-1308 by The Associated Gas Distributors ("AGD"), is limited to one important and novel feature of the Federal Power Commission's opinion establishing a nationwide rate for new gas production.[1] This is the Commission's automatic application of the higher rate it established for new gas to the oldest and cheapest vintages of flowing gas, at a multibillion dollar cost to gas consum-

[1] The issue has also been raised in the petition filed by the American Public Gas Association (APGA) in Case No. 75-1304.

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ers, whenever the producer and pipeline enter into a new sales contract at the expiration of the initial contract.

The Commission's Brief in Opposition [2] does not purport to deny the great and continuing significance of the issue. Moreover, since the Commission's action of which we complain constitutes a marked departure from its actions in the previous area rate proceedings considered by this Court, the Commission cannot and does not suggest that the questions raised by New York and AGD are disposed of by the Court's decision in the *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), or *Mobil Oil Corporation* v. *Federal Power Commission*, 417 U.S. 283 (1974). Instead, without any serious effort to discuss the specific contentions made by New York as to the deficiencies in the Commission's and Court of Appeals' justifications for this multibillion dollar non-cost increase in the rates producers can charge for flowing gas without assurances that any portion of this huge fund would be devoted to further efforts for the interstate gas market, the Commission confines itself to citing the court's recital of its own inadequate findings and conclusions.

The Court below believed that in view of the still "experimental" nature of producer pricing, a "kid glove treatment" of otherwise inadequate Commission findings was required (Pet. App. A-19). Under this standard of review it believed that the huge non-cost allowance could be justified in view of the Commission's general finding that an adequate gas supply effort would require a "massive commitment of new funds" and the court's erroneous reading of the Commission opinions as find-

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[2] Pursuant to leave granted by this Court, the Commission's opposition to New York's petition, and five others seeking review of the same Court of Appeals opinion, was filed on May 27, 1976 under the style of "The California Company, et al. v. Federal Power Commission".

ing that "internally generated funds are a *necessary* source of such funds" (Pet. App. A-29, emphasis added),[3] coupled with the Commission's expressed hope "that by requiring an old contract to be renegotiated before the new rate is recoverable, the pipeline *might* be able to negotiate for additional acreage dedication to interstate commerce, or exploration and development activity on previously dedicated acreage, or other concessions for the price increase" (*ibid.*). The court of appeals also apparently believed that the Commission's action in authorizing the multibillion dollar allowance was excusable since it was "tentative" and subject to reconsideration in the biennial review proceeding the Commission had initiated in the light of its evaluation therein of whether the additional revenues generated had in fact led to greater gas search efforts. (Pet. App. A-30). The Commission Brief in Opposition significantly does not rely on this part of the opinion below. This is because, as New York stated in its petition, the only reconsideration of this matter the Commission apparently intends to entertain in the biennial review proceeding is as to whether the still higher new gas rate established therein should be made available to the oldest and cheapest vintages of flowing gas.

If this were a situation such as that presented in the *Mobil* case *supra*, where potentially large non-cost increases in flowing gas revenues were authorized only to

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[3] While the Commission found that much of the capital for producer production efforts had typically come from gas production revenues (Pet. App. D-16, D-55-56), it did *not* find that internally generated gas revenues were the "necessary" source of funds for an optimum gas search effort. It could not do so in view of record data as to the availability of other funds if the opportunity price is right (see, *e.g.*, Pet. App. C-267-270) and industry experience in virgin areas such as the North Slope of Alaska and the North Sea. See *Public Service Commission of the State of New York* v. *Federal Power Commission*, 487 F.2d 1043, 1073 (D.C. Cir., 1973), remanded *sub nom.*, 417 U.S. 964 (1974).

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the extent that additional gas was in fact dedicated to the interstate market, it might be less important for the Commission to have some factual basis for believing that at least a substantial portion of its largesse would be devoted to additional efforts to secure gas for the interstate market.[4] But even in such circumstances and even if the Commission's determination was in fact a tentative one subject to prospective recission in the biennial review proceeding, it would not have justified the Commission's complete refusal to address itself in any of its opinions to the arguments against its proposal made by New York, AGD, and the American Public Gas Association, or to make any effort to evaluate the results of a similar, if more limited, experimental program it had initiated two years earlier. The court below recognized its responsibility was to ensure that the "Commission has exercised its discretion after considering all pertinent options" (Pet. App. A-29). The simple fact is that the Commission made no effort to do so before granting the producers a multibillion non-cost allowance for which no *quid pro quo* was required.

Even if it is assumed that the establishment of an appropriate new gas price approximately double that previously in existence would be inadequate to induce the necessary additional effort by the producers in the absence of an increased cash flow from existing gas sales, (but see n.3, *supra*), the method chosen by the Commission for achieving this objective was unsupportable. The Commission itself recognized that it "cannot set a price for new gas without also considering the cash flow consequences of its pricing policies for old gas" (Pet. App.

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[4] Thus the contingent escalations of flowing gas rates approved by this Court in the *Mobil* case *supra*, never became effective since the producers did *not* dedicate the requisite additional volumes of gas to the interstate market. This is also true with respect to the contingent escalation provisions included in several other Commission area rate orders.

C-97). However, it made no effort to consider whether any conceivable inadequacy of the cash flow available under the flowing gas rates of its pre-existing area rate orders would be eliminated by higher national rates for flowing gas to be established in the separate proceeding it had established for that purpose in Docket No. 478.[5] Equally important, the Commission completely ignored the arguments of New York and AGD that automatically granting producers the new gas price when they are able to persuade the pipeline to enter into a new contract not only would not lead to substantial new investment on behalf of the interstate market but would be likely to detract from the efficacy of the Commission's existing programs to use price as a regulatory tool to induce new efforts in behalf of the interstate market.

If, contrary to New York's view, it could be demonstrated that an optimum increase in production efforts on behalf of the interstate market required a discrete increase in gas revenues over the ensuing six years of the magnitude indicated by the Commission's action in permitting producers to charge the new gas rate for their oldest and cheapest gas, (and this revenue increase would not in any event result from the increased rates to be authorized for flowing gas), the first questions one would expect the Commission to consider were why such increases should be assigned to the oldest and most rapidly depleting vintages of flowing gas rather than as a

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[5] In Opinion No. 749 in Docket No. 478, issued on December 31, 1975, the Commission fixed the nationwide rate for old gas at a level of 23.5 cents per Mcf, escalating to 29.5 cents per Mcf as of July 1, 1976. The great bulk of rates for gas classifiable as old gas was sold under rates established by the pre-existing area rate orders at levels considerably below either figure, ranging down to 12.5 cents for gas produced in the Panhandle and Hugoton fields in Kansas. (In those few cases where the old gas area price was above the nationwide level fixed by the Commission, the higher area rate prevails.) On February 27, 1976 the Commission granted rehearing of Opinion No. 749 for the purpose of further consideration of a number of petitions for rehearing.

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per Mcf allowance for all old gas,[6] and why such allowance, regardless of the vintage of flowing gas to which it is applied, should not, as a minimum, be tied to a pledge by the recipient producer to expend the amount received in additional gas supply efforts for the interstate market. No such consideration appears to have been given by the Commission prior to adoption of its program here. It simply is not good enough for the Commission to suggest that its insistence that the new gas price will be available only when producer and pipeline enter into a replacement contract, *might* give some of the pipelines sufficient leverage to require some *quid pro quo* for the increased revenues. In a period of acute gas shortage the far more likely possibility is that if the pipelines with expiring sales contracts wish to secure any of the offshore gas the producers might then or in the future have for sale (and are in any event obligated to sell to the interstate market) they will have to agree to sign new contracts which would authorize the producer to secure the new gas levels for their flowing gas.

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[6] Thus the Commission noted (Pet. App. C-96, n. 118) that in some area rate orders it had provided an additional non-cost allowance of several cents per Mcf to provide what it believed was an adequate cash flow for future reinvestment. A two cent per Mcf surcharge on the approximately 22.5 Tcf of flowing gas produced as of the end of 1972 (Pet. App. C-126), assuming depletion at a level of 10% per year, would produce additional revenues of about $2,075,964,000 over the same 8 year period Commissioner Smith utilized in estimating the cost of the Commission's allowance in issue here. But unlike the Commission's plan, which would start out in 1974 with a yield of about $127.2 million and build up to an annual amount of $560.7 million in 1981, an across the board surcharge would produce the largest sum at the beginning of the eight year period when it assertedly is most needed. Equally important, any across the board surcharge, even if it was tied to producer reinvestment of the additional revenues in gas production efforts on behalf of the interstate market, would retain a substantial differential between new and old gas rates, and thus continue to provide an incentive for producers to upgrade production on their existing wells in return for further price concessions.

The Commission appears to suggest at page 15 of its Opposition that in view of the gas supply shortage it can, in effect, establish whatever higher producer rates it believes appropriate and gas consumers then have the burden of demonstrating that its conclusion is utterly devoid of rational content. Recognizing that a reviewing court cannot substitute its or our judgment for that of the Commission where it fixes upon a course of conduct after considering all available evidence and the arguments pro and con, nothing this court has previously stated can be interpreted as providing the Commission with the blank check which it seeks here.

The Commission neither proposed to make its national new gas rate applicable to flowing gas sold under renewable contracts in its various notices in the rulemaking proceeding or sought to secure a record on this question (though it requested comments on many other facets of the new gas rate.). It has ignored all arguments against its action. It has refused to examine the available record of its earlier similar experiment to test the validity of our claims that the expanded program, far from producing any substantial increase in interstate gas supply to match its huge cost, would be likely to lessen the existing incentive of producers to up-grade their flowing gas operations through well reconditioning or other undertakings in return for a rate increase. And it gave no apparent consideration to possible alternatives which would be less costly or more effective. Under these circumstances it is imperative that this Court grant the petitions for certiorari which seek to review the Commission's action which permits producers to collect billions of additional dollars in revenues, unrelated to their costs, but does not require them to devote any portion thereof to efforts to increase the gas supply for the consumers required to pay the tab.

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CONCLUSION

For the reasons set forth herein and in the initial petition filed by New York, the question of the validity of the Commission's action authorizing the nationwide new gas to be automatically available to old low cost gas sold under replacement contracts is both novel and of great importance to the proper exercise of the Commission's responsibilities under the Natural Gas Act. Certiorari accordingly should be granted to review this facet of the court of appeals opinion below.

Respectfully submitted,

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